

LIMITING STATE-LOCAL TAX DEDUCTIBILITY
IN EXCHANGE FOR INCREASED GENERAL REVE-
NUE SHARING: AN ANALYSIS OF THE ECONOMIC
EFFECTS

PREPARED FOR THE
SUBCOMMITTEE ON INTERGOVERNMENTAL
RELATIONS
OF THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
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IN EXCHANGE FOR INCREASED GENERAL REVENUE SHARING:
AN ANALYSIS OF THE ECONOMIC EFFECTS

Prepared at the Request of the
Senate Committee on Governmental Affairs
Subcommittee on Intergovernmental Relations

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and

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June 2, 1983

(III)

LETTER OF TRANSMITTAL

U.S. SENATE,
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C., July 13, 1983.

Hon. WILLIAM V. ROTH, Jr.,
Chairman, Committee on Governmental Affairs, Washington, D.C.

DEAR MR. CHAIRMAN: I am herewith transmitting for printing as a committee print a study entitled "Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects." This study was done by the Congressional Research Service at my request as Chairman of the Subcommittee on Intergovernmental Relations.

Given the continuing interest in limiting tax expenditures and the President's efforts to bring about Federalism reforms, I believe this study will be useful as a committee print for both Members of Congress and the Executive Branch.

Sincerely,

DAVE DURENBERGER,
*Chairman, Subcommittee on
Intergovernmental Relations.*

Enclosure.

(v)

CONTENTS

	Page
Letter of Transmittal.....	v
List of Tables.....	ix
List of Figures.....	ix
List of Appendix Tables.....	ix
Summary.....	1
Introduction.....	7
I. PRESSURES FOR LIMITING THE DEDUCTIBILITY OF STATE AND LOCAL TAXES.....	9
II. THE COMPARATIVE EFFICIENCY OF FEDERAL INTERGOVERNMENTAL ASSISTANCE THROUGH GRANTS-IN-AID, TAX-EXEMPT BONDS, AND STATE-LOCAL TAX DEDUCTIBILITY.....	13
A. Transfer Efficiency between the Federal and State-Local Levels.....	13
B. Social-Administrative Efficiency at the State-Local Level.....	17
C. Implications for the Composition of Intergovernmental Aid.....	20
III. RATIONALES FOR AND AGAINST STATE-LOCAL TAX DEDUCTIBILITY UNDER THE FEDERAL TAX CODE.....	23
A. Historical Precedents for Disallowing Deductibility of Certain State-Local Taxes.....	23
B. The Issues of Discretionary and Quasi-Private Public Consumption.....	27
IV. EFFECTS OF TAX DEDUCTIBILITY ON STATE-LOCAL FISCAL CHOICES.....	30
A. The Mechanics of Deductibility.....	30
B. Increasing the Size of the State-Local Sector.....	31
C. Encouraging Greater Progressivity in State-Local Tax Systems.....	32
D. Not Biasing State-Local Choices Among Types of Revenue Sources.....	34
E. Buffering Tax Differentials Among Jurisdictions.....	35
V. DISTRIBUTIONAL IMPLICATIONS OF ALTERNATIVE DEDUCTIBILITY—LIMITATION PROPOSALS AMONG INCOME GROUPS AND AMONG THE STATES.....	38
A. Four Proposals for Limiting Deductibility.....	38
B. Revenue Estimates.....	39
C. Summary of Conclusions.....	41
D. Expected Increase in Federal Tax Liability Among Income Groups.....	42
E. Variation in the Effect of the Alternative Proposals Among the States.....	51
VI. AN EVALUATION OF A SPECIFIC PROPOSAL TO EXCHANGE A PARTIAL LIMITATION OF STATE-LOCAL TAX DEDUCTIBILITY FOR AN INCREASE IN GENERAL REVENUE SHARING.....	64
A. Questions Raised by the Proposal.....	65
B. Caveats Regarding the Numerical Estimates.....	65
C. Organization of the Chapter.....	66
D. The Effect on State-Local Own-Source Revenues of Limiting the Deductibility of State-Local Taxes From the Federal Individual Income Tax: Income and Price Effects in the Federal Offset.....	67
E. Net Effect on Taxpayers, the State-Local Budget, and the Federal Budget of Increasing General Revenue Sharing and Limiting State-Local Tax Deductibility.....	71
1. Proposal to Place a Floor on All State-Local Tax Deductions.....	73
2. Proposal to Eliminate the Deductibility of Sales Taxes.....	76

VIII

VI. AN EVALUATION OF A SPECIFIC PROPOSAL—Continued

F. Potential Own-Source Revenue Loss for Each of the States -----	Page 80
APPENDIX A: Background Statistics for Analysis of Increased Tax Liability by Income Group (Chapter V) -----	85
APPENDIX B: Background Statistics for Analysis of Increased Tax Liability by State (Chapter V) -----	91
APPENDIX C: The Federal Offset and the Income Effect (Chapter VI) -----	96

LIST OF TABLES

TABLE 1. Federal Aid to State and Local Governments, FY80 and FY 83	Page 21
TABLE 2. Anticipated Federal Revenue Effect of Alternative Proposals to Limit the Deductibility of State and Local Taxes, FYs 1983-1987	40
TABLE 3. Marginal Tax Rates and Percent of Returns Itemizing State-Local Taxes, by AGI Class, 1980	44
TABLE 4. State-Local Tax Deductions: Average Size and Relationship to Adjusted Gross Income, by AGI Class, 1980	46
TABLE 5. Limiting Deductibility: Underlying Factors Influencing the Increase in Federal Tax Liability by State, 1980	53
TABLE 6. Eliminating Sales Tax Deductibility: The Increase in Federal Tax Liability by State, 1980 Basis	56
TABLE 7. Limiting Tax Deductibility as a Percent of AGI: The Increase in Federal Tax Liability by State, 1980 Basis	59
TABLE 8. Potential Revenue Loss as a Percent of 1980 Total Tax Revenue, by State: One Percent of AGI Floor and Elimination of Sales Tax Deductibility	81

LIST OF FIGURES

FIGURE 1. Increase in Tax Liability as a Percent of AGI for the AGI Class as a Whole, 1980	48
FIGURE 2. Increase in Tax Liability as a Percent of AGI for an Individual Itemizer, by AGI Class, 1980	50

LIST OF APPENDIX TABLES

APPENDIX A

TABLE A.1. For All Returns: Total AGI and Number; For Itemized Returns: Number Itemizing State and Local Taxes of Any Kind, and Number Itemizing Sales Taxes; All Categorized by AGI Class, 1980	85
TABLE A.2. Average AGI and Average Taxable Income for Returns with Itemized Deductions; Joint Returns as a Percent of all Returns; All Categorized by AGI Class, 1980	86
TABLE A.3. Estimated Loss of Deduction for an Itemizer under Alternative Proposals, by AGI Class, Based on 1980 Tax Return Data	87
TABLE A.4. Estimated Increase in Tax Liability for an Individual Itemizer, by AGI Class, 1980 Deduction Data and Tax Rates	88
TABLE A.5. Estimated Increase in Tax Liability as a Percent of AGI for an Individual Itemizer, by AGI Class, 1980 Deduction Data and Tax Rates	89
TABLE A.6. Estimated Increase in Tax Liability as a Percent of AGI for the AGI Class as a Whole, 1980 Deduction Data and Tax Rates	90

APPENDIX B

TABLE B.1. Percentage Breakdown of State-Local Tax Deductions by Type of Tax, within Each State, 1980	91
TABLE B.2. Average Dollar Size of Deduction by Type of State-Local Tax, by State, 1980	93
TABLE B.3. A Comparison of Direct Tax Burdens for a Married Couple with Two Dependents, Based on Median Income Reported by FHA-Insured Mortgagors Located in the Largest City in Each State, 1980	95

SUMMARY

The provision permitting the deduction of taxes paid to State and local governments from the Federal individual income tax base is under serious scrutiny. The Revenue Acts of 1964 and 1978 established legislative precedents for curbing the deductibility of fees and taxes paid to State and local governments by eliminating the deductibility of motor-vehicle license fees and of excise taxes, including those on gasoline. The repeal of sales and personal property tax deductibility was considered in deliberations over the Tax Equity and Fiscal Responsibility Act of 1982.

Given the continuing fiscal pressures on the Federal Government, it is useful to devote attention to the choice among the four major types of deductibility-limitation proposals that have surfaced: 1) eliminate the deductibility of the sales tax; 2) place a ceiling on the deductibility of all State-local taxes; 3) place a floor, fixed at the same dollar amount for all taxpayers, on the deduction for all State-local taxes; and 4) set a floor as a percent of AGI.

The desirability of limiting State-local tax deductibility should be evaluated within the context of the entire system of intergovernmental financial assistance. State-local tax deductibility is only one of the three major methods the Federal Government has for subsidizing State-local activities. The largest source of support is grants-in-aid, which include categorical grants, block grants, and general revenue sharing. A third source of support is the subsidy to State-local borrowing through the exclusion of bond interest from Federal income taxation.

Of these three types of intergovernmental assistance, direct grants-in-aid are the most efficient in the sense that each dollar of Federal cost provides a full dollar of revenue to the State-local sector. In contrast, because they operate indirectly through their influence on Federal taxpayers, tax deductibility and bond interest exclusion provide considerably less than a dollar of revenue to the State-local sector for each dollar of Federal cost. Furthermore, from the perspective of the State-local sector, general revenue sharing is considered to be the most socially and administratively efficient type of grant-in-aid.

In spite of these advantages, general revenue sharing remains the smallest category of intergovernmental aid. Grants overall grew far less rapidly between fiscal years 1980 and 1983 than did the tax expenditure cost of tax deductibility and bond interest exclusion. This suggests that consideration might be given to some shifting of the budget cost from these tax expenditures to increased funding of general revenue sharing. One specific proposal is to finance an increase in general revenue sharing with the additional Federal revenues from limiting State-local tax deductibility.

The historical reason for allowing deductibility was not so much to provide a subsidy to State and local governments, but more to avoid "taxing a tax," that is, to avoid taxing individuals on income used to make payments over which taxpayers were felt to have no discretionary control. Deductibility helped avoid confiscatory cumulative Federal-State-local income tax rates during the period when the top Federal marginal tax rates were very high (they peaked at 90 percent in 1944-45).

But even at the outset of the Federal income tax in 1913, user charges and special assessments were not deductible because they were considered to be payments for specific services. Over time, some general-purpose taxes also

have had their deductibility removed, for a variety of reasons. For example, it was considered inappropriate that, simply because of small differences in their legal specification, taxes levied by some States were considered deductible, while taxes of other States, although essentially the same in their economic incidence, were not deductible. Some, such as gasoline excise taxes and motor-vehicle license fees, were considered to be user fees. Some, such as alcohol and cigarette excise taxes, were sumptuary taxes designed in part to discourage consumption, and deductibility was viewed as counterproductive in this regard. For some, it was administratively unmanageable for the IRS to determine a taxpayer's legitimate deductions.

In addition, State-local tax deductibility has come under criticism recently in response to a growing perception that the services provided by some State-local governments have expanded beyond providing just basic public services and that deductibility is in essence subsidizing private consumption through the public sector. If this is the case, it is not clear that even all general-purpose State-local tax payments merit deductibility.

A decision to limit deductibility also depends to some extent on its effects upon State and local government fiscal choices. It may raise the price of public goods relative to the price of private goods, thereby causing a reduction in the level of own-financed State and local spending. Limiting deductibility may further discourage State and local governments from using a more progressive tax system. Allowing deductibility for some taxes but not others may bias the choice among State-local revenue sources. And, finally, limiting deductibility would tend to reduce the Federal buffer on effective tax differentials among State-local jurisdictions. The various limitation proposals are likely to produce different mixtures of these effects.

While the four alternative deductibility-limitation approaches are comparable in the revenue they are expected to yield to the Federal Government, they are quite different in their implications for who would be paying those higher Federal taxes. By the standard of progressivity across income classes, the least progressive proposal would be the fixed dollar floor on all State-local tax deductions. While the proposals to eliminate the deductibility of the sales tax and to set a ceiling on all State-local tax deductions appear moderately progressive when viewed on a nationwide basis, their effects are distributed quite unevenly among taxpayers in different States. Repealing the deductibility of a particular tax, such as the general sales tax, would have little effect on residents of States where that tax was not levied; the additional Federal tax revenues would come mainly from residents of States that relied on the sales tax as an important revenue source. Setting a ceiling on the deductibility of State and local taxes would raise the Federal tax liability for residents of high-tax States, and might not raise the Federal tax liability of residents of low-tax States much at all.

This leaves setting a floor that lies below the average tax burden of even the lowest-tax State as the alternative that is most progressive and that appears to spread the burden of higher Federal taxes most even-handedly among taxpayers in different States.

The sales tax and percent of AGI floor deductibility limitations are considered in conjunction with a proposed expansion of the general revenue sharing (GRS) program. The exchange of State-local tax deductibility for general revenue sharing, under either limitation proposal, has the effect of reducing taxpayers' after-tax incomes, increasing Federal tax revenues, and increasing the State-local sector's revenues, although the State-local sector's increase in GRS receipts is somewhat offset by a reduction in own-source tax revenues.

Taxpayers are found to be slightly better off in terms of after-tax income with the sales tax proposal. The State-local sector's budget, in contrast, is somewhat better off with the floor proposal, while the Federal budget fares better with the sales tax proposal. The primary reason for these differences is the nature of the taxpayers' expected response to the two proposals. Their desire to reduce State-local tax payments is expected to be greater under the sales tax proposal because it raises the relative price of public compared to private goods as well as reducing taxpayers' incomes, whereas the floor proposal only reduces their incomes. The choice of the particular limitation proposal is, therefore, a matter of considerable importance to the State-local sector because of the differing implications for their likely own-source revenue loss.

In addition, the sales tax proposal appears to distribute the loss of own-source revenues more unevenly across the States than does the floor proposal. This is attributable to the fact that some States either do not levy a sales tax or raise a relatively small share of their revenues from it. In contrast, the average itemizer's State-local tax deductions exceed 1.0 or 1.5 percent of AGI in every State, so that every State's itemizers are likely to be affected by the floor proposal. Thus, the type of limitation proposal selected also is important to considerations of geographic equity.

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AN ANALYSIS OF THE ECONOMIC EFFECTS

INTRODUCTION

Continuing fiscal pressures make further broadening of the Federal income tax base a serious possibility. The provisions for deductibility of State and local taxes have already been singled out for review. Therefore, those concerned with issues of intergovernmental finance may wish to consider the choice among the alternative deductibility-limitation proposals that have surfaced. It is also an opportunity to re-evaluate the role of State-local tax deductibility within the overall system of Federal intergovernmental assistance.

This report addresses several issues to be considered in that evaluation. Chapter I summarizes the recent pressure in Congress to limit the deductibility of State and local taxes and describes the four major limitation mechanisms that have been proposed. Chapter II considers State-local tax deductibility within an overall framework of Federal aid to State and local governments. The efficiency of transferring assistance through tax deductibility is compared to that of direct grants and tax-exempt bonds. The growth of these separate forms of intergovernmental assistance is traced between fiscal years 1980 and 1983.

Support for limiting State-local tax deductibility depends not only on Federal budgetary pressures, but also upon whether its possible effects are consistent with other public policy guidelines and objectives. Chapter III reviews both historical and contemporary arguments for disallowing the deduction of certain State-local taxes and charges. Chapter IV discusses expected economic

effects of deductibility on the fiscal choices of State and local governments, including the level of State-local spending, the progressivity of the State-local tax structure, the choice among revenue sources, and tax differentials among jurisdictions.

Chapter V compares how four limitation proposals could be expected to distribute the increase in Federal tax liability among income groups and among the States. Chapter VI concentrates on two of the limitation proposals--eliminating the deductibility of sales taxes or placing a floor of one percent of AGI on the deductibility of all State-local taxes. It couples each of these with a proposal to increase the funding of the general revenue sharing (GRS) program. It estimates the likely net effect of the combined GRS and deductibility-limitation proposals on the budgets of taxpayers, the Federal Government, and the State-local sector as a whole. It also provides estimates for each State of the potential loss in own-source tax revenue as taxpayers react to a limitation of the deductibility of State and local taxes.

I. PRESSURES TO LIMIT THE DEDUCTIBILITY OF STATE AND LOCAL TAXES

The tax-favored status of State and local governments under the Federal individual income tax is coming under serious scrutiny, in part due to immediate congressional concern with raising revenue, and in part due to broader, longer-range efforts to reform the tax system. Of particular interest in this report are proposals to limit the deductibility of State and local (S-L) taxes under the Federal individual income tax. 1/

There is considerable recent legislative precedent for trimming the list of State and local taxes eligible for deduction. The Revenue Act of 1964 eliminated the deductibility of S-L license fees and of excise taxes other than on gasoline. The Revenue Act of 1978 eliminated the deductibility of State gasoline excise taxes. Since 1979, four major types of State and local taxes have remained eligible for deduction: individual income, real estate, personal property, and general sales. 2/

1/ Another area under examination is tax-exempt bonds. Congress has placed limits on the extent of their use and has considered taxing interest from municipal bonds under the alternative minimum tax for individuals. Under the Tax Equity and Fiscal Responsibility Act of 1982, for financial institutions, as part of the scale-back of corporate tax preferences, Congress disallowed 15 percent of otherwise allowable interest deductions allocable to the purchase of tax-exempt obligations acquired after 1982. See: U.S. Congress. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. December 31, 1982: 32, 97-110.

2/ Certain other S-L taxes, of lesser revenue importance, are eligible for deduction if they are ordinary and necessary expenses of producing income. These include, for example, State transfer taxes on the sales of stocks and bonds, and occupational taxes charged at a flat rate by a locality for the privilege of working in the locality.

Among these four taxes, the sales tax is the one that is most frequently nominated as the next candidate for elimination of deductibility. ^{3/} Although not included in the final tax bill, repealing the deductibility of the sales tax and personal property tax was seriously considered in both Senate and House discussions behind the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA); the House also considered repealing the deduction for nonbusiness income taxes. ^{4/} Under the more sweeping reform suggested by most flat rate tax proposals, essentially all deductions would be repealed, including the deductions for all State and local taxes. Only the Bradley-Gephardt proposal for a progressive, broad-based tax makes a special provision for State and local taxes. It would repeal the deduction for State and local taxes other than income and real property taxes: this implies a repeal of both the personal property and sales tax deductions. ^{5/}

Pressures to raise Federal revenues persist in reaction to projections of continuing large Federal budget deficits. If the Congress remains committed to the lower marginal tax rates brought about by the Economic Recovery Tax Act of 1981 (ERTA) and yet is reluctant to broaden the tax base to the full extent recommended in the flat rate tax or consumption tax proposals, an intermediate

^{3/} See, for example: U.S. Congress. Congressional Budget Office. Reducing the Deficit: Spending and Revenue Options. February 1983. p. 315-316.

^{4/} U.S. Congress. Joint Committee on Taxation. Description of Possible Options to Increase Revenues. Prepared for the Committee on Finance, U.S. Senate. June 15, 1982. p. 77-79. Also: U.S. Congress. Joint Committee on Taxation. Description of Possible Options to Increase Revenues. Prepared for the Committee on Ways and Means, U.S. House of Representatives. July 16, 1982. p. 152-154.

^{5/} U.S. Congress. Joint Committee on Taxation. Analysis of Proposals Relating to Broadening the Base and Lowering the Rates of the Income Tax. Prepared for the use of the Senate Committee on Finance. Washington, September 24, 1982. p. 33-35.

path to pursue is the approach exemplified in TEFRA: partially restricting existing tax preferences in a wide variety of functional areas. For example, TEFRA raised the floor on the medical expense deduction from three percent to five percent of AGI and eliminated the separate deduction for health insurance payments. TEFRA also imposed a ten-percent-of-AGI floor on the casualty loss deduction, on top of the existing \$100-floor deduction for each loss.

In the discussions behind TEFRA, several alternative proposals for limiting the State-local tax deduction were considered. One general approach would target a particular type of tax: completely eliminate the deductibility of the sales tax, and perhaps the personal property tax. The other general approach would treat all S-L taxes in combination but would limit the total dollar amount that could be deducted. Three specific limitation mechanisms were considered: a) place a ceiling on the deductibility of all S-L taxes (amounts above the ceiling would not be deductible); b) place a floor, fixed at the same dollar amount for all taxpayers, on the deduction for all S-L taxes (only amounts above the floor would be deductible); and c) set a floor as a percent of AGI (only S-L taxes paid in excess of that percent of a taxpayer's AGI would be deductible).

Possibly because it appears to follow in the line of historical precedent, the policy option which appears to attract the most political support upon initial mention is eliminating the deductibility of the sales tax. However, the analysis of the economic effects of the S-L tax deductibility provisions presented in this report suggests that if some limitation of the State-local tax deduction is to be made, the proposal of setting a floor as a percentage of AGI is the alternative which would have the least disruptive effect across States and local jurisdictions and among taxpayers.

With continuing fiscal pressures making further tax-base broadening a possibility, 1983 presents a good opportunity for a re-examination of the public policy arguments that are given in support of the tax preferences that pervade the tax code. In light of the particular vulnerability of State-local deductibility provisions, it may be useful to devote attention to the choice among the alternative proposals that have surfaced, and at the same time, to re-evaluate the role of State-local tax deductibility in the intergovernmental financial system.

II. THE COMPARATIVE EFFICIENCY OF FEDERAL INTERGOVERNMENTAL ASSISTANCE THROUGH GRANTS-IN-AID, TAX-EXEMPT BONDS, AND STATE-LOCAL TAX DEDUCTIBILITY

The Federal Government has three methods for subsidizing State-local activities. First, direct support for State-local spending is provided through grants-in-aid, consisting of categorical grants, block grants, and general revenue sharing. Second, the borrowing of State-local government is subsidized by excluding the interest earned on State-local bonds from the Federal income tax base. Third, taxation by State-local governments is subsidized by allowing the deduction of State-local taxes from the Federal income tax base. For fiscal year (FY) 1983 grants-in-aid were expected to cost the Federal Government \$93.5 billion in direct expenditures, the interest exclusion was expected to cost \$13.7 billion in foregone tax revenues, and tax deductibility was expected to cost \$28.8 billion in foregone tax revenues. ^{6/}

A. Transfer Efficiency between the Federal and State-Local Levels

The question arises as to whether a dollar of cost to the Federal Government from these three types of subsidy provides an identical amount of benefit to the State-local sector. The extent to which a dollar of subsidy provides less than a dollar of spendable resources can be thought of as a measure of the inefficiency of transferring dollars of assistance from the Federal Government to the State-local sector. By this standard of measure, grants seem to perform fairly well;

^{6/} U.S. Office of Management and Budget. Special Analyses, Budget of the United States Government, Fiscal Year 1984 (Washington, D.C.: U.S. Govt. Print. Off., 1983). Grants-in-aid estimates from T. H-8 on p. H-20; tax expenditure estimates calculated from entries in T. G-2 on p. G-31 to G-33. For details, see source note to table 1 of this report.

that is, for each dollar of cost to the Federal Government, the State-local sector receives a full dollar.

The tax-exempt subsidy to State-local borrowing is less efficient in converting a dollar of Federal revenue loss into resources available to State and local governments. A substantial proportion of the revenues lost to the Federal Government via this exclusion of State-local bond interest from Federal taxable income accrues to the Federal taxpayers who hold the bonds rather than to the State-local sector.

To attract buyers for its bonds, the State-local sector must pay an interest rate which provides a return equal to the after-tax return that an investor can earn on a corporate bond of equivalent risk. Because a corporate bond is taxable, a taxpayer's return is reduced to the proportion $(1-t)$, where t is the taxpayer's Federal marginal tax rate. In other words, the after-tax return earned by the purchasers of corporate bonds is substantially lower than the interest rate paid on the bond. Because the State-local bond is not taxable, it only has to offer an interest rate comparable to the after-tax return earned on corporate bonds in order to be a competitive alternative investment. ^{7/}

The State-local sector is subsidized by the difference in market-clearing interest rates between taxable and tax-exempt bonds. If all State-local bonds could be sold to taxpayers in the highest Federal marginal tax bracket, currently 50 percent, then the entire Federal revenue loss would benefit the State-local sector. However, all of the State-local bonds placed on the market generally cannot be sold to taxpayers in the highest marginal tax bracket.

^{7/} Investors also take into account the consequence of State and local income taxation. State and local bond interest which is exempt from Federal taxation may be subject to State and local income taxation by jurisdictions other than the one issuing the bond.

Consequently, taxpayers with lower marginal tax rates must be induced to purchase the bonds. Since individuals at lower marginal tax rates earn a higher after-tax return on corporate bonds than individuals in the highest marginal tax bracket, the S-L bond is relatively less attractive to individuals in the lower marginal brackets. In order to induce lower tax rate individuals to buy State-local bonds, the market-clearing interest rate on State-local bonds must rise to the level where it equals these individuals' higher after-tax corporate bond return.⁸ All State-local bonds are sold at this higher market-clearing interest rate, even though higher marginal tax rate taxpayers receive a return greater than is necessary to induce them to buy the bonds. Thus, a substantial portion of the Federal revenue loss is a windfall gain to buyers of State-local bonds with marginal tax rates above the market-clearing rate.^{8/}

For January 1983, for example, Moody's average interest rate for municipal bonds was 9.85 percent and for corporate bonds, 12.9 percent. Thus, tax-exempt rates were 76 percent of taxable rates, implying that the market-clearing marginal investor was down in the 24-percent tax bracket, and that all bondholders in tax brackets above that were receiving these windfall gains.^{9/}

The subsidy to State-local taxation performs even less well than the subsidy to borrowing in terms of transfer efficiency. This is attributable primarily to the indirect nature of the subsidy--the initial beneficiary of the deduction is the State-local taxpayer, whose after-tax income is increased. The benefit to the State-local sector depends upon the willingness of the taxpayer to spend this increase in after-tax income on public rather than private consumption.

^{8/} These windfall gains are described in: David Ott and Allen H. Meltzer. *Federal Tax Treatment of State and Local Securities*. Washington, D.C.: The Brookings Institution, 1963.

^{9/} See: Moody's Investors Service, *Moody's Bond Record*, vol. 50, no. 2 (February 1983). p. 2, 151.

For itemizers, the deductibility of State-local taxes against the Federal taxable income base (compared to a system which does not allow deductibility) reduces the cost of a dollar of State-local tax, and correspondingly reduces the price of a dollar of State-local spending. The price declines from \$1 to $\$1(1-t)$, where t is the Federal marginal tax rate. Assuming a national average marginal tax rate for State-local tax itemizers of 34 percent, ^{10/} the marginal price of public services for itemizers falls from \$1.00 to \$.66. Thus, for itemizers, the price of public service consumption is reduced 41 percent relative to the price of private goods and services. ^{11/}

If it is assumed that itemizers determine State-local fiscal decisions, they will cause the sector to increase its provision of public services. The magnitude of this increase depends upon the sensitivity of itemizers' preferences for public goods to price changes--that is, on the nature of their demand for public goods. This sensitivity is often referred to as the price elasticity of demand, a number which specifies what the percentage change in the quantity of goods or services purchased will be in response to a percentage change in the price of the good or service.

A middle-of-the-range estimate of the price elasticity of demand for public goods is about $-.5$. ^{12/} This means that a one-percent decrease (increase)

^{10/} Office of Tax Analysis, U.S. Department of the Treasury, May 1982. We continue to use this 1980 tax rate estimate unadjusted, based on the assumption that the reduction in tax rates brought about by the Economic Recovery Tax Act of 1981 will be approximately counterbalanced by inflation in income over the period 1981-1984.

^{11/} The measure of the percentage change in price differs depending on whether the original price is the base ($.34/1.00=34$ percent) or the new price is the base ($.34/.66=52$ percent). This discrepancy is resolved by averaging the original and new prices $((1.00+.66)/2=.83)$ and substituting this for the base ($.34/.83=41$ percent).

^{12/} Robert F. Inman. Fiscal Performance of Local Governments, in: Peter Mieszkowski and Mahlon Straszheim, eds. Current Issues in Urban Economics. Baltimore: The Johns Hopkins University Press, 1979.

in price would generate a one-half percent increase (decrease) in public spending. This implies that, on average, the percentage increase in public spending induced by deductibility of S-L taxes would be expected to be half the 41 percent reduction in price, or 20.5 percent. That is, State-local taxpayers would be willing to pay 20.5 percent of their Federal tax savings in higher State-local taxes. This estimate suggests that for every dollar of Federal revenue foregone because of State-local tax deductibility, State-local governments receive only \$.205, while taxpayers' after-tax incomes rise by \$.795. Should itemizers not play a decisive role in determining State-local fiscal decisions, however, it is possible that State-local tax deductibility has an even lower level of efficiency in translating Federal revenue losses into benefits to the State-local sector.

The foregoing discussion suggests that grants-in-aid are the most efficient of the three Federal subsidy mechanisms in use. Each dollar of Federal cost for grants-in-aid provides a full dollar of revenue to the State-local sector. Both the exclusion of interest on tax-exempt bonds and the deductibility of State-local taxes are indirect means of subsidy which must work through taxpayers. This round-about approach causes a substantial discrepancy between the Federal revenue cost and the amount of funds available for the State-local sector to spend.

B. Social-Administrative Efficiency at the State-Local Level

Although the transfer of dollars from the Federal Government to S-L governments is very efficient in the case of grants, there is another aspect of efficiency which may affect the relative benefits received by the State-local sector from the three major types of grants-in-aid--categorical grants, block grants, and general revenue sharing. This can be called social-administrative efficiency. When the Congress creates separate grants for many different programs, it is establishing spending priorities in conformance with its own view

of social objectives. From the Federal perspective, these separate grants are socially efficient in the sense that they reallocate resources from the private sector, through taxation, to specific public functions judged to provide greater benefits to society. Accomplishing these congressional goals in turn requires fairly specific restrictions on how these grant dollars are to be spent, and substantial administrative guidelines and reporting requirements to ensure compliance with Federal objectives. These administrative costs are considered costs of accomplishing the Federal social objectives.

The State-local perspective, however, is different. State-local officials stress that needs and priorities vary a great deal across the fifty States, and within the States across very different kinds of local governments. From their perspective, grants-in-aid are much more likely to be socially efficient if State-local officials have the flexibility to take their diverse needs into account when establishing spending priorities. In addition, the reduction of administrative guidelines and reporting requirements should enable more of the grant dollars to be spent on the actual provision of public services, and less on paperwork.

It should be noted that with any of the forms of grants assistance, State-local governments may be able, in spite of Federal restrictions, to use some of each dollar received to repay outstanding debt or to lower taxes rather than to increase spending. This is usually accomplished by reallocating funds among budget functions or by increasing own-financed spending less rapidly than planned. This behavior merely suggests that these alternative uses to which some portion of the dollars received may be devoted are worth more to the State-local sector than is additional public spending. ^{13/}

^{13/} For a review of the extensive literature on State-local governments' spending response to Federal grants, see: Edward M. Gramlich. *Intergovernmental Grants: A Review of the Empirical Literature*, in: Wallace E. Oates, ed. *The Political Economy of Fiscal Federalism*. Lexington, Mass.: Lexington Books, 1977.

The three types of grants-in-aid rank quite differently on the criteria of social-administrative efficiency. Categorical aid, almost by definition, generally is accompanied by mandates to provide special services, reporting requirements to ensure compliance, and other provisions requiring minimum service levels or maintenance-of-effort. From the State-local perspective, categorical grants rank low in social and administrative efficiency.

As for block grants, although claims have been made of an efficiency advantage of up to 25 percent, a more conservative figure offered by organizations representing the States is a block grants advantage relative to categorical grants of about 10 percent.^{14/} This suggests that efficiency gains can be achieved from converting categorical grants to block grants, thereby allowing the State-local sector more discretion in setting spending priorities and reducing administrative red tape so that more dollars can be applied to serving the problems of high State-local priority.

No similar exchange rate has been suggested between block grants and even less restrictive general revenue sharing (GRS). Following the reasons set forth above, it might be expected that conversion of block grants to unconditional grants such as GRS would generate even more social and administrative efficiencies. What work has been done in this area suggests that GRS may have lower administrative costs than block grants.^{15/}

^{14/} U.S. Library of Congress. Congressional Research Service. Block Grants: The Administrative Costs Issue, by Sandra S. Osbourn. Washington, April 1, 1981. Typed report. p. 3.

A GAO analysis found no sizeable reduction in administrative costs associated with the major blocks grants created prior to 1981. See: U.S. General Accounting Office. Lessons learned from Past Block Grants: Implications for Congressional Oversight. Washington, September 23, 1982. p. 52-65. (GAO/IPE-82-8)

^{15/} The GAO report (82-8) compared estimates of administrative costs associated with different types of grants. Estimates of administrative costs as-
(continued)

C. Implications for the Composition of Intergovernmental Aid

In summary, the discussion in this chapter suggests that grants-in-aid are the most efficient subsidy mechanism available to the Federal Government in the sense of maximizing the proportion of the Federal revenue cost that becomes available to the State-local sector for spending on public goods. Furthermore, from the perspective of the State-local (but probably not the Federal) sector, general revenue sharing is considered to be the most socially and administratively efficient type of grant-in-aid.

Yet general revenue sharing remains the smallest category of intergovernmental aid. As shown in table 1, the dollar level of funding for the GRS program has actually fallen, from \$6.8 billion in FY 1980, to \$4.6 billion FY 1983. This reduction reflects the fact that the State portion of GRS was eliminated effective in FY81. In the Reagan Administration's budget proposals for FY82, 83, and 84, efforts to reorder Federal aid to State and local governments focused on consolidating numerous categorical grants into fewer block grants, and trimming the rate of growth in the overall level of grant funding. The reduction in GRS offset about half the growth in categorical and block grants, with grants as a whole growing by only \$2.1 billion, or 2.3 percent, between FY80 and FY83. (Of the \$93.5 billion in intergovernmental grants estimated for FY83, categorical account for \$75.3 billion or 80.5 percent, broad-based (block) grants for \$11.8 billion or 12.6 percent, and general purpose grants

(continued) associated with categorical programs were found to span a wide range. Administrative costs for block grants fell within that range, though toward the lower end. Administrative costs associated with general revenue sharing are collected on a different accounting basis than those associated with categorical or block grants, thereby impeding direct comparison. What statistics are available suggest that administrative costs associated with GRS may be considerably lower than those for block grants. See: GAO. Lessons Learned from Past Block Grants. p. 52-65.

TABLE 1. Federal Aid to State and Local Governments, FY80 and FY83.
(billions of dollars)

Form of aid	FY80 (actual)	FY83 (estimate)	Absolute Change FY80-83	Percent Change FY80-83
<u>Grants</u>				
General purpose grants	8,594	6,445	-2,149	-25.0
General revenue sharing	6,829	4,567	-2,262	-33.1
Broad-based (block) grants	10,332	11,832	1,500	14.5
Other (categorical) grants	72,546	75,260	2,714	3.7
TOTAL, GRANTS	91,472	93,537	2,065	2.3
<u>Tax expenditures</u>				
Exclusion of interest on State and local bonds <u>a/</u>				
General obligation bonds	4,925	8,000	3,075	62.4
Revenue bonds <u>b/</u>	2,772	5,775	3,003	108.3
TOTAL, TAX EXEMPTION	7,697	13,775	6,078	79.0
Deductibility of State and local nonbusiness taxes <u>a/</u>				
Property taxes on owner- occupied homes	7,310	8,765	1,455	19.9
Other nonbusiness State and local taxes	14,690	20,060	5,370	36.6
TOTAL, TAX DEDUCTIBILITY	22,000	28,825	6,825	31.0

a/ The tax expenditure revenue-loss figures for exclusion of interest on State and local bonds include estimates under both the corporation and individual income tax. The tax expenditure estimates for State-local tax deductibility are from the individual income tax only. Because State and local taxes are considered a normal business expense, their deduction is not treated as a tax expenditure item for corporation income tax purposes, or for sole proprietorship or partnership income tax purposes.

b/ The category of revenue bonds includes the following classifications detailed in the tax-expenditure budget: industrial development, pollution control, owner-occupied housing, rental housing, student loan, hospital, mass transit, and energy production facilities.

Source: Grant-in-aid data from U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1984 (Washington, D.C.: U.S. Govt. Print. Off., 1983), Table H-8 on p. H-21. Tax expenditure estimates for 1983 calculated from entries in Table G-2 on p. G-31 and G-32; tax expenditure estimates for 1980 from Special Analyses, FY82, Table G-1 on p. 226-30.

\$6.4 billion or 6.9 percent, including \$4.6 billion of general revenue sharing.) ^{16/} Over the same period, FY80 to FY83, aid in the form of tax expenditures grew substantially. The estimated tax expenditure cost associated with tax-exempt bonds grew by \$6.1 billion, an increase of 79 percent, and the cost of State and local tax deductibility grew by \$6.8 billion, an increase of 31.0 percent.

The preceding analysis of the relative efficiency of transferring aid by different methods suggests that for a dollar in revenue foregone by the Federal Government, State-local governments receive more in spendable resources if aid is given in the form of direct grants rather than deductibility of State-local taxes. It suggests further that among the three types of grants-in-aid, GRS is the most efficient. Nonetheless, according to statistics on the trends in Federal financial assistance to State and local governments presented in table 1, between FY 1980 and FY 1983 GRS experienced an absolute decline and grants as a whole remained essentially unchanged, while tax expenditures associated with tax deductibility and the tax-exempt status of interest on bonds grew substantially.

In light of these considerations, when examining and reconsidering its overall package of Federal aid to State and local government, the Federal Government might consider shifting some of its subsidy from the category of tax deductibility to general revenue sharing. A specific proposal to this end is examined in detail in chapter VI.

^{16/} See source note to table 1. The category of general purpose grants also includes such items as permanent appropriations by the Forest Service and Bureau of Land Management, payments in lieu of taxes, and the Federal payment to the District of Columbia. See Special Analyses, FY84 Budget, table H-11 on p. H-33 and H-34.

III. RATIONALES FOR AND AGAINST STATE-LOCAL TAX DEDUCTIBILITY UNDER THE FEDERAL TAX CODE

In the past the Congress has drawn on several lines of reasoning in its decisions to limit the deductibility from Federal individual income taxation of certain taxes and charges levied by State and local governments. The first part of this chapter reviews some of the historical reasons for disallowing the deductibility of State-local special purpose taxes, user charges, and excise taxes--reasons primarily concerned with the proper definition of taxable income and difficulties in tax administration. The second part of the chapter raises some of the contemporary challenges to permitting deductibility of the full amount of general-purpose taxes that individuals pay to S-L governments. These challenges stem from observations of the wide variation in the public services provided by different S-L governments and from the related perception that S-L taxpayers may have some discretion over the amount of taxes they pay.

A. Historical Precedents for Disallowing Deductibility of Certain State-Local Taxes

The major focus of this report is on how the deductibility of S-L taxes affects State-local government revenue and expenditure behavior. This is motivated by the suggestions of economic theory, explained in further detail in chapter IV, that deductibility of S-L taxes should enhance the revenue-raising ability of subnational governments. It should be emphasized, however, that the provision of S-L tax deductibility was probably not instituted with the primary intention of offering a subsidy to State and local governments. Rather, it was more likely introduced--from the outset of the Federal individual income tax

in 1913 ^{17/}--on the grounds of "not taxing a tax" or, expressed another way, of not taxing income obligated to expenditures over which the taxpayer was felt to have no discretionary control.

The tax-deductibility provision has been defended on the grounds of State and local sovereignty in revenue raising. There was concern that without Federal deductibility the cumulative rate of Federal-State-local taxation would reach confiscatory levels, approaching a 100 percent marginal tax rate at the highest income levels. This loomed as a serious threat when the maximum Federal tax rate reached its peak of 90 percent in 1944-45, but has become less so as the maximum Federal rate dropped to 70 percent in 1971, and most recently to 50 percent as of January 1, 1982.

Interestingly, from the outset of the Federal income tax, two categories of payments which were perceived as directly linked to specific services provided by S-L governments have not been deductible. One is user charges, such as those for sewer and water services, or special fees paid for use of facilities, such as recreation and cultural facilities. The other is special assessments (also known as local benefits taxes) for property improvements, such as construction of sidewalks and drainage systems. The taxes considered appropriate for deduction were general-purpose taxes paid by individuals, as well as taxes that qualified as a cost of doing business or producing income.

In subsequent years, even some of the general-purpose S-L taxes which were deductible under the original 1913 income tax law have had their deductibility

^{17/} State and local taxes along with Federal taxes were the only deductions specifically provided for in the Income Tax Act of 1861. State and local taxes have remained deductible under every income tax statute enacted since 1861. See: Harry E. Brazier. *The Deductibility of State and Local Taxes Under the Individual Income Tax*, in: U.S. Congress. Committee on Ways and Means. *Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base*, v. 1 (Washington, D.C.: U.S. Govt. Print. Off.). November 16, 1959. p. 407.

disallowed. In particular, the Revenue Act of 1964 eliminated the deductibility for motor vehicle operators' license fees and State and local excise taxes, other than on gasoline. The deductibility of the excise tax on gasoline was eventually eliminated by the Revenue Act of 1978.

Four types of arguments were mounted against deductibility in the congressional deliberations behind these changes in the tax code. One was that differences among the States in the legal specification of taxes that were essentially the same in terms of their economic incidence caused some States' taxes to be considered deductible, while others were not. A current example of this is the disparity in treatment of personal property taxes on motor vehicles. If a motor vehicle registration fee is levied on the basis of a vehicle's value, it is deductible from the Federal income tax, but if it is determined on the basis of vehicle weight, it is not deductible. Another example involves the taxation of gasoline (motor fuel): while some States levy a nondeductible excise tax, others levy a deductible general sales tax.

A second argument used against the deductibility of gasoline taxes and motor vehicle license fees was that they were more like a user charge for highways than a general-purpose tax, and that users should not be subsidized by non-users through Federal deductibility.

A third argument was that excise taxes, in the role of sumptuary taxes, are designed in part to discourage the consumption of the taxed items, particularly in the case of alcohol and cigarettes. Subsidizing the consumption of these items by permitting Federal deductibility of the S-L excise tax was seen as contrary to this policy. During the energy crisis of 1978, the role of the excise tax in discouraging gasoline consumption was summoned as an argument for repealing its Federal deductibility. In addition, the payment of excise taxes was viewed as being determined by the individual's discretionary decision

to consume the taxed products, and hence as a discretionary tax. Some argue that the general sales, personal property, and real estate taxes are similarly related to discretionary consumption decisions.

The fourth and perhaps most persuasive argument behind the elimination of the excise tax deductions was the difficulty that taxpayers had in estimating or keeping records of the amounts they spent on these taxes, and the accompanying difficulty that the IRS faced in determining the amounts that people actually spent on such items as alcohol, cigarettes, and gasoline. (Because these taxes were of comparatively minor revenue importance to State and local governments and consequently of small Federal tax-expenditure cost compared with the deductibility of broad-based taxes, the debate surrounding their elimination centered mainly on this issue of the administrative costs, uncertainties and unfairness involved in the IRS trying to ascertain whether individuals had actually paid in taxes the amount they claimed as deductions.)

It might be tempting to levy the same challenge of administrative uncertainty against the general sales tax and the personal property tax. Admittedly, taxpayers are unlikely to have accurate records of the amounts they pay for sales taxes on the many purchases they make in the course of a year. However, most taxpayers use the sales tax tables to determine the amount of their deduction; this means that the estimates made by the IRS essentially control the size of the deduction claimed. And taxpayers are likely to have receipts for amounts claimed in addition to the tax table estimates, which are generally for big-ticket items permitted as add-ons, such as a car, boat, or airplane. Taxpayers are similarly likely to have good records of the amounts of personal property taxes paid to State and local governments on such major items as an automobile or holdings of financial assets. (Interestingly, however, their own difficulty in administering the tax has led many State and local governments

to stop levying a personal property tax on household furnishings and financial assets.)

B. The Issues of Discretionary and Quasi-Private Public Consumption

There is a growing perception that the services provided by some State and local governments have expanded well beyond the basics of preserving public health and safety. Some publicly-provided services can be viewed as substitutes for private consumption and in that sense as discretionary expenditures. Popular examples include recreational facilities such as swimming pools, golf courses, and tennis courts. But even such a basic service as garbage collection can be viewed as a private-good substitute, particularly when individuals or businesses pay for the private provision of those same services in other jurisdictions. ^{18/} According to IRS rules, when a municipality charges a separate fee for trash and garbage pick-up, this fee is not considered deductible as part of real estate taxes; ^{19/} however, if the charge for this sanitation service is included in the general fund millage rate, it is deductible. This suggests that the quasi-private nature of some S-L services can be used as an argument for disallowing the deductibility of at least some portion of general-purpose S-L taxes, including sales, property, and income taxes.

The tax treatment of homeowners' associations fees provides a current test case involving the issues of the public provision of private services and

^{18/} The extent to which the goods and services being provided by local governments could be provided in the necessary quantities by the private sector has been discussed extensively in the economics literature. See: Theodore D. Bergstrom and Robert P. Goodman. Private Demands for Public Goods. *American Economic Review*, v. 63, no. 3, 1973; and Robert M. Spann. Public Versus Private Provision of Government Services [in] Thomas E. Borchertding, ed. *Budgets and Bureaucrats: The Sources of Government Growth*. Duke University Press. 1977.

^{19/} Department of the Treasury, Internal Revenue Service. *Your Federal Income Tax--For Individuals* (for use in preparing 1982 returns). Publication 17 (Rev. Nov. 82). p. 91.

the discretionary component of public fees. These associations would like to have the fees they charge their members be treated as local taxes for the purpose of deductibility against Federal and State income taxes. Homeowners' associations do provide some services that otherwise might need to be provided by a local jurisdiction, such as street cleaning. To date, however, requests for the deductibility of homeowners' association fees generally have been turned down by legislatures; one of the reasons for refusal is that part of the fees are used to purchase services which in most communities would be considered private consumption items--such as maintenance of the exteriors of dwellings and tending the grounds.

The question of whether to classify S-L taxes as discretionary expenditures is an important issue in the discussion of the consumption tax, a tax concept based on the general idea that the disposition of income can be divided into the two broad categories of saving and consumption. Under the consumption tax view, additions to saving would be eligible for deduction, whereas expenditures for consumption purposes would not be deductible. Where would S-L taxes be classified in this framework--as deductible savings or nondeductible consumption? ^{20/} Does this call for a distinction to be made between tax payments for public capital expenditures versus current operating expenses?

In sum, the above examples and the available research suggest that there may be a substantial discretionary component underlying the level of even broad-based, general-purpose taxes. The guideline of not permitting deduction of consumption-related taxes has been used as an argument for limiting the

^{20/} This question remains open to debate even in the academic literature. See: Michael J. Graetz. *Expenditure Tax Design* [in] Joseph A. Pechman, ed. *What Should Be Taxed: Income or Expenditure?* Washington, D.C.: The Brookings Institution, 1980. p. 233-234.

deductibility of excise taxes, and could be applied to the general sales tax, the personal property tax, and the real estate tax. The tax base for all of these levies can be seen as related to the taxpayer's discretionary level of spending for the taxed items. Among S-L taxes, then, only the income tax is spared this challenge of being directly related to private consumption. ^{21/} But even the income tax falls under the challenge that because some S-L services are quasi-private or discretionary in nature, the deductibility of at least some portion of general-purpose S-L taxes could reasonably be disallowed, just as the deductibility of user fees is disallowed.

^{21/} An analysis of the appropriate treatment of State and local taxes within the framework of the model comprehensive income tax reaches a similar conclusion, granting the deductibility of income taxes but not other State and local taxes. See: U.S. Department of the Treasury. Blueprints for Basic Tax Reform. January 17, 1977. p. 86-88.

IV. EFFECTS OF TAX DEDUCTIBILITY ON STATE-LOCAL FISCAL CHOICES

The previous chapter focused on the statutory reasons for and against deductibility under provisions of the Federal tax code, with a primary emphasis on defining the appropriate base of taxable income for individuals. This chapter considers reasons for and against deductibility in the context of the expected economic effect on State and local government fiscal choices. These governmental finance considerations have for the most part replaced the historical concern about confiscatory taxation of individuals as the prime justification for retaining deductibility.

In order to facilitate the discussion, it is useful to begin the chapter with a brief review of the mechanics of the deductibility provision, the source of its influence on economic behavior.

A. The Mechanics of Deductibility

For people who itemize deductions on their Federal individual income tax return, the Federal Government in effect subsidizes their deductible S-L tax payments in direct proportion to their Federal marginal tax rate.¹ For someone in the 44-percent Federal tax rate bracket, for example, an extra dollar of S-L income tax liability means a net increase in combined Federal-State-local (F-S-L) tax payments of only 56 cents. The remainder of that dollar tax increase is offset by a 44-cent decrease in Federal taxes otherwise owed. For someone in the 12-percent bracket, an increase of a dollar in a deductible S-L tax means an out-of-pocket net increase in combined F-S-L tax liability of 88 cents, with 12 cents offset by a decrease in Federal tax liability.

People who do not itemize do not feel any direct influence of the deductibility provision: an additional dollar in S-L taxes means a full dollar out-of-pocket for them. For charges by State and local governments which are not deductible (such as user charges and special property assessments), nonitemizers and itemizers alike view an additional dollar charge as costing them a full additional dollar. This partial absorption of the cost of an additional dollar of S-L tax revenue--by the reduction in an itemizer's Federal tax liability--is viewed by economists as subsidizing the price of S-L public services.

B. Increasing the Size of the State-Local Sector

Just as the deduction for interest, originally introduced as a business expense provision, has come to be viewed as a subsidy for owner-occupied housing, the deduction for State and local taxes, originally instituted to refine the definition of an individual's taxable income, has come to be viewed as a means of subsidizing S-L governments' efforts to raise revenues from their own sources.

This subsidy can be viewed as encouraging efforts toward greater revenue self-sufficiency, and, implicitly, as reducing the need for Federal intergovernmental aid. This could be viewed as consistent with the long-range goal of President Reagan's 1981 New Federalism proposal to turn back both revenue-raising and expenditure responsibility for certain programs to State and local governments.

But subsidizing S-L taxation through deductibility also can be viewed as imparting a bias toward larger government by encouraging public over private provision of goods and services. This aspect of deductibility could be viewed as in conflict with President Reagan's objective of reducing the size of government at all levels.

The public-sector bias occurs because of two effects on people who itemize deductions on their Federal individual income tax return. First, a dollar paid

through a deductible tax should appear cheaper than a dollar paid privately, so an incentive exists to switch consumption of certain types of goods and services from the private to the public sector. Second, the subsidized price of public goods creates an incentive to consume a greater quantity of goods and services typically produced in the S-L public sector. Limiting deductibility, by raising the price of public goods relative to the price of private goods, may cause a reduction on the level of own-financed State and local spending.

C. Encouraging Greater Progressivity in State-Local Tax Systems

In theory the deductibility of S-L taxes could be expected to encourage S-L officials to make any given tax source more progressive, particularly in high-income States.^{22/} Taxpayers who already face high Federal tax rates would be expected to be less resistant to higher S-L tax rates than people in low Federal tax brackets. This is because a deduction, by its very nature, offers a larger percentage subsidy--in the form of lower Federal taxes--the higher a taxpayer's Federal marginal tax rate. Thus, Federal deductibility acts to cushion the progressivity of S-L tax burdens. The net effect of the Federal offset, when State-local taxes are considered in combination with Federal taxes, is to make a proportional S-L system regressive, and an already regressive S-L system even more regressive. Federal deductibility should, therefore, encourage S-L governments to use a more progressive tax system--in the sense of taxing higher income people at higher rates than lower income people.

^{22/} Most analysis has focused on the State income tax and the incentive that Federal deductibility provides for using a system of graduated rates rather than a flat rate. See, for example: Edward Moscovitch, *State Graduated Income Taxes--A State-Initiated Form of Federal Revenue Sharing*, *National Tax Journal*, v. 25, no. 1, March 1972, p. 53-64. See also: Robert I. Keller, *The Case for Highly Graduated Rates in State Income Taxes*, *Maryland Law Review*, v. 35, no. 4, 1976, p. 617-650.

As an intergovernmental policy goal, the Federal Government might want to encourage S-L governments to use more progressive revenue systems in order to take some burden off the Federal income tax as the agent of redistribution through the tax system. In general, however, there is resistance to the idea of making S-L taxes progressive. Activities which redistribute from the rich to the poor are considered best left to the Federal level of government because taxpayers are less able to avoid Federal taxes by moving to another jurisdiction. Limiting deductibility could further discourage State and local governments from using a more progressive tax system.

On the other hand, if statistical evidence could document that the current structure of the Federal tax benefit for S-L taxes was not encouraging more progressive S-L tax systems, and if greater progressivity in S-L tax structures is a Federal goal, it might be appropriate to reevaluate the current deductibility provisions as the form of Federal subsidy. A Federal tax credit, for example, could compensate S-L taxpayers across all income levels more effectively than a deduction. ^{23/}

As is explained in detail in chapter V, the alternative proposals for limiting S-L tax deductibility have different implications for progressivity. Placing a floor as a percent of AGI reserves greater Federal tax benefits for more progressive S-L tax systems. In contrast, placing a fixed dollar floor would reward high-income relative to low-income taxpayers, regardless of the relative progressivity of the S-L tax system. The measures that would do most to discourage the progressivity of S-L tax systems would be setting a low ceiling (at either a fixed dollar amount or a percentage of AGI) or disallowing the deductibility of the income tax.

^{23/} Walter W. Heller. Deductions and Credits for State Income Taxes, in: Committee on Ways and Means, Compendium of Papers on Broadening the Tax Base, 1959. p. 419-33.

D. Not Biasing State-Local Choices Among Types of Revenue Sources

In the past, Congress has expressed its desire not to interfere with S-L governments' choice among revenue sources. During the deliberations behind the Revenue Act of 1964, the reasoning given by the Committee on Ways and Means for the continuation of the deduction for the sales tax along with the property and income taxes was as follows:

Your committee finds no disagreement with the House in the reasons given for the desirability of continuing the deductibility of property taxes, income taxes, and general sales taxes. In the case of property taxes, it was suggested that any denial of the deduction would result in an important shift in the distribution of Federal income taxes between homeowners and nonhomeowners. In the case of State and local income taxes, it was suggested that the continued deductibility of these taxes represents an important means of accommodation to take into account the fact that both State and local governments on one hand and the Federal Government on the other hand tap this same important revenue source. A failure to provide deductions in such a case could mean a combined burden of income taxes which in some cases would be extremely heavy. It was further indicated that, if property and income taxes are to be deductible for Federal income tax purposes, it also is important to allow the deduction of general sales taxes. To deny the deductibility of general sales taxes while allowing deductions for the other major revenue sources would encourage State and local governments to use these other resources in place of the sales tax. Your committee agrees with the House that it is important for the Federal Government to remain neutral as to the relative use made of these three forms of State and local taxation. ^{24/}

The influence of the deductibility provision on S-L governments' choice of revenue sources becomes a more important consideration for Federal policy decisions when the tax contributes a large fraction of S-L revenues--as the sales tax does, or when those who pay the tax face a large payment--as is sometimes the case for personal property taxes paid on a motor vehicle.

Because eliminating the deductibility of the general sales tax (or the personal property tax) would raise the price of a dollar of sales tax (or

^{24/} U.S. House of Representatives. Committee on Ways and Means. Legislative History of H.R. 8363, 88th Congress, The Revenue Act of 1964, P.L. 88-272, Part 3. 89th Cong., 2d sess. Washington, U.S. Govt. Print. Off. p. 2556.

personal property tax) revenue relative to a dollar of revenue from other deductible taxes, it could influence S-L revenue officials to disfavor those revenue sources in favor of others which remain deductible. For these reasons, if the S-L tax deduction is to be limited, it seems preferable in the interest of avoiding Federal interference in S-L revenue choice to select an alternative that would limit the deductibility of all S-L taxes considered together, rather than singling out a particular type of tax and eliminating its deductibility completely.

We are in an era of heightened attention to possible alternatives for "privatizing" the provision of public services. Homeowners' associations are one example of this. Another is a renewed emphasis on user charges at the local level as a way of discouraging waste in the demand for public services. This raises the larger question of whether, if the objective were to move the Federal Government toward a more neutral stance on S-L financing methods, it would be appropriate to expand the deductibility provisions in order to encompass, at least partially, user charges and fees, or to move instead in the other direction of restricting the deductibility of general-purpose taxes.

E. Buffering Tax Differentials Among Jurisdictions

One side-effect of the deductibility of S-L taxes is to narrow effective tax differentials among States and local jurisdictions. For example, for someone in the 50-percent Federal tax bracket, the difference between living in a State with a 10-percent income tax rate and one with a 4-percent rate is not the full 6-percent rate differential, but .50 times 6, or 3 percent. For someone in the 34-percent bracket, the effective difference would be $1.00 - .34$, or .66, times the 6-percent rate differential, equalling 4 percent. ^{25/} A non-

^{25/} For a more detailed illustration of the effect of Federal deductibility on interarea tax differentials, see: Benjamin Bridges, Jr. *Deductibility of State and Local Nonbusiness Taxes Under the Federal Individual Income Tax*. *National Tax Journal*, v. 19, no. 1, March 1966. p. 1-16.

itemizer, however, would feel the full effect of the 6-percent S-L tax differential.

To the extent that S-L tax differentials may discourage the location of economic activity in high-tax jurisdictions, the current deductibility provisions should benefit high-tax States and localities. That is, S-L governments which levy deductible taxes at higher than average rates have their competitive disadvantage buffered by the deductibility provision. Because this buffer is proportional to the taxpayer's marginal tax rate, it should have a stronger effect in high-income States, or to be more precise, those States in which more residents are likely to be in higher Federal marginal tax brackets. In contrast, residents of low-tax jurisdictions receive a relatively small absolute dollar subsidy from Federal deductibility, particularly if they also are in low Federal tax brackets. Consequently, although they maintain an absolute advantage, jurisdictions with low State and local taxes lose some of their relative competitive advantage as a result of the Federal deductibility provisions. Limiting deductibility would tend to reduce the Federal buffer on effective tax differentials among State-local jurisdictions.

A floor approach to limiting any deduction conveys the message that the amount of expenditure up to the floor is considered "normal" or "reasonable," and that no subsidy is deserved for S-L revenue-raising efforts up to that floor. In contrast, only expenditures in excess of that limit are considered exceptional drains on income suitable for Federal offset. A ceiling approach conveys the message that the Federal Government is willing to subsidize that expenditure item only up to a certain dollar limit. This limit may represent just a token amount, or may attempt to represent the estimated "necessary" or "reasonable" amount of expenditures--amounts above which are considered to reflect personal discretion and therefore not to be deserving of Federal subsidy. These signals

are implicit in the choice between a floor and a ceiling approach to limiting the deductibility of State and local taxes.

The implications of the four alternative deductibility-limitation proposals on individuals at different income levels and under different S-L revenue systems are examined in greater detail in chapter V. In brief, a ceiling-style limitation is likely to raise the Federal tax liability of residents of high-tax jurisdictions relative to residents of low-tax jurisdictions. Because a floor approach would raise Federal tax liability of taxpayers in almost all S-L jurisdictions, residents of high-tax jurisdictions would be relatively better off than under a ceiling approach because the burden of increased Federal taxes would be shared by residents of low-tax jurisdictions as well. Conversely, as a percentage of their S-L tax liability, residents of low-tax jurisdictions would experience a greater loss of deductions than residents of high-tax jurisdictions under a floor approach, and would be relatively better off under a ceiling approach.

V. DISTRIBUTIONAL IMPLICATIONS OF ALTERNATIVE DEDUCTIBILITY-LIMITATION PROPOSALS
AMONG INCOME GROUPS AND AMONG THE STATES

A question of perennial interest surrounding any proposed or accomplished change in the tax law is "what are its distributional effects?" This question most often refers to the pattern of change in the tax burden across income groups, and leads to a conclusion about the relative progressivity or regressivity of the tax provision. Another interpretation of the distributional question, one particularly relevant to the analysis of proposals to limit the deductibility of State and local taxes, is "how will the resulting increase in Federal tax liability affect residents of different State and local taxing jurisdictions?"

To respond to these two distributional questions, this chapter compares the expected increase in Federal tax liability from the alternative proposals to limit the deductibility of State and local taxes. It does this, first, on a nationwide basis across income classes and, second, across the States for all their taxpayers treated as a group.

A. Four Proposals for Limiting Deductibility

Four alternative mechanisms have been proposed as a means of raising additional Federal revenues by limiting the provisions for the deductibility of State and local taxes under the Federal individual income tax. In the discussions behind TEFRA, the revenue goal was to raise approximately \$5 billion in additional revenues as of FY85.

Proposal one would completely eliminate the deductibility of the sales tax. The other three proposals would treat the deductible taxes--general sales, personal income, real estate, and personal property--in combination, and would place a floor or ceiling on the dollar amount that could be deducted.

Proposal two would set a fixed dollar floor on deductions. Only taxes in excess of the floor amount would be eligible for deduction. Using its tax model, the Joint Committee on Taxation estimated that a floor of \$375 for single filers and \$750 for married couples filing joint returns would raise \$6 billion in revenues for FY85. ^{26/} (Because the calculations made in this chapter are based on data from 1980 tax returns, these dollar figures have been converted, using the GNP deflator, into their 1980 equivalents of \$282 on single returns and \$564 on joint returns. ^{27/})

Proposal three would express the floor as a percentage of adjusted gross income. The Joint Committee on Taxation's model indicated that a floor set at one percent of adjusted gross income (AGI) would raise approximately an additional \$5 billion in Federal revenues for FY 1985.

Proposal four would set a ceiling as a percentage of AGI. State-local tax payments above that ceiling would not be eligible for deduction. The Congressional Research Service has estimated that a ceiling set at 6.5 percent of AGI would raise revenue approximately equal to the other three proposals.

B. Revenue Estimates

These four proposals are treated as essentially revenue-equivalent for the purposes of this chapter's comparison of distributional effects. It should be pointed out, however, that calculations made both as part of this analysis and by the Joint Committee on Taxation suggest that there may be substantial differences in the revenue implications of the four proposals as they now stand.

^{26/} Joint Committee on Taxation estimate as of May 1983.

^{27/} The Office of Management and Budget estimate of the GNP deflator for 1985 as of April 1983 was 237.7, compared with a value of 178.64 for 1980, or a 33 percent increase over the five-year period.

Table 2 presents the Joint Committee on Taxation's (JCT) revenue estimates, covering fiscal years 1984 through 1988, for four different limitation proposals: a one percent of AGI floor; a fixed floor of \$375 for single returns and \$750 for joint returns; repeal of the sales tax deduction; and a 1.5 percent of AGI floor. No JCT revenue estimates were made for a ceiling proposal. The projections suggest that the one percent of AGI floor proposal would produce somewhat less revenues than either the fixed dollar floor or sales tax deduction repeal proposals, whereas a 1.5 percent floor approach would produce somewhat more revenue.

The CRS estimates of the expected increase in tax revenues that would have occurred as of 1980 are presented in the last column of table 2. The CRS

TABLE 2. Anticipated Federal Revenue Effect of Alternative Proposals to Limit the Deductibility of State and Local Taxes, FYs 1983-1987.
(in billions of dollars)

Proposal	Joint Committee on Taxation Projections					CRS Benchmark
	FY1984	FY1985	FY1986	FY1987	FY1988	Tax Year 1980
1% of AGI floor	0.6	4.6	4.7	5.3	6.1	3.4
Repeal sales tax deduction	0.8	5.1	5.7	6.4	7.2	3.7
\$375/\$750 floor	0.9	5.9	6.0	6.6	7.3	4.3
1.5% of AGI floor	1.0	6.5	6.9	7.9	9.0	5.1
Ceiling at 6.5% of AGI	NE	NE	NE	NE	NE	3.1

Note: NE = not estimated.

Source: Joint Committee on Taxation. Estimates made in May 1983, assuming the proposals would take effect as of January 1, 1984. Figures in last column estimated by CRS.

estimates are considerably smaller than the Joint Committee estimates, but they show a similar ranking among the proposals in terms of expected revenue yield.

The difference in magnitude between the JCT and CRS estimates is largely explained by the fact that the JCT model and data files are "aged" or adjusted to incorporate the effect of assumptions about inflation, growth of income and deductions, and reductions in Federal tax rates scheduled by the Economic Recovery Tax Act of 1981. The CRS estimates, in contrast, are based on 1980 IRS data for income, State-local tax deductions, and marginal tax rates. ^{28/} Thus, the CRS estimates are by no means expected to reflect the actual dollar increase in taxes that would occur in future years, but rather were developed to compare the pattern of increase in Federal tax burden across income groups and among States.

C. Summary of Conclusions

The main point of this chapter is to illustrate that while the four alternative proposals may be comparable in the revenue they are expected to yield

^{28/} There are other reasons to expect differences between the CRS and JCT estimates. First, the CRS estimates are based on aggregate average numbers. These are data available in printed form from the Statistics of Income Division of the Internal Revenue Service. Thus, the CRS figures are rough estimates, made without benefit of the fine-tuned tax models used by the Treasury Department's Office of Tax Analysis (OTA) or the Joint Committee on Taxation which are based on individual income tax returns. These models can take into account the dispersion around an average income or deduction figure, and the possibility that some itemizers may fall out of itemizing status or move into higher tax brackets as the result of losing some deductions.

Also, OTA and JCT revenue estimates for these proposals are net of the offsetting revenue reduction expected as a result of a portion of State-local tax refunds (the portion associated with the disallowed deduction) no longer being treatable as taxable income. The CRS estimates concentrate only on the revenue effects of the reduced eligible itemized deductions, before this refund offset is taken into account.

to the Federal Government, they may have quite disparate implications for who would be paying those higher Federal taxes, depending on what income group the taxpayer may be in or what State-local revenue system they may live under. The conclusions are summarized briefly here at the outset to provide a focus for the detailed analysis which follows in the next two sections.

By the standard of progressivity across income classes, this analysis concludes that the least progressive proposal would be the fixed dollar floor on all State-local tax deductions, and the most progressive would be the percent-of-AGI floor. While the proposals to eliminate the deductibility of the sales tax or to set a ceiling on all State-local tax deductions appear moderately progressive when viewed on a nationwide basis, their effects are expected to be distributed quite unevenly among taxpayers in different States. This is because of the substantial differences among State-local tax systems.

Repealing the deductibility of a particular tax, such as the general sales tax, would have little effect on residents of States where that tax was not levied; the additional Federal tax revenues would come mainly from residents of States that relied on the sales tax as an important revenue source. Setting a ceiling on the deductibility of State and local taxes would raise the Federal tax liability of residents of high-tax States, and might not raise the Federal tax liability of residents of low-tax States much at all. This leaves setting a floor that lies below the average tax burden of even the lowest-tax State as the alternative that appears to spread the burden of higher Federal taxes most even-handedly among taxpayers in different States.

D. Expected Increase in Federal Tax Liability among Income Groups

A standard part of the analysis of almost any tax proposal is an evaluation of whether the tax is considered progressive or regressive. A tax provision is described as progressive if it imposes a heavier tax liability relative to

income on high income groups than low income groups. It is described as *regressive* if that tax burden is higher for low compared with high income groups. It is described as *proportional* if the increase in tax liability is an equivalent percentage of income for all income groups. There has generally been a preference that Federal taxes be progressive rather than regressive.

Any proposal to raise revenues through the Federal income tax necessarily means that taxpayers as a group will experience an increase in their Federal tax liability. Proposals to raise revenues by limiting eligible deductions ^{29/} concentrate the increase in tax liability on the subset of taxpayers who itemize deductions. ^{30/} Because over 99 percent of itemized tax returns claim deductions for State and local taxes of some kind, the proposals under consideration would in essence mean an across-the-board increase in Federal taxes for itemizers. ^{31/}

Simply as a result of the mechanics of itemizing under a progressive tax structure, the increase in tax liability from limiting deductions would tend to be greater for itemizers who face high marginal tax rates and for groups of taxpayers which have a high fraction of their members itemizing the particular deduction subject to the new limitation. Statistics presented in table 3 illustrate that both the proportion of taxpayers who itemize and the average marginal tax rate those itemizers face rise with income. As a result, a

^{29/} This can be contrasted with raising revenues by increasing tax rates across the board or making taxable certain forms of income that are now exempt or excluded from taxation.

^{30/} This conclusion assumes that the zero bracket amount would not be reduced in conjunction with the limitation of eligible deductions. Non-itemizers--including taxpayers who claim only the zero bracket amount and people whose income falls below the cutoff for incurring any tax liability--benefit indirectly from deductions to the extent that the existence and use of deductions raises the level at which the zero bracket amount is set.

^{31/} Calculated by CRS from data presented in: Internal Revenue Service. *Statistics of Income--1980, Individual Income Tax Returns*. Washington, D.C.: U.S. Govt. Print. Off., 1982. Publication 79 (9-82). (Elsewhere referred to as 1980 SOI.) Table 2.1, p. 56.

TABLE 3. Marginal Tax Rates and Percent of Returns Itemizing State-Local Taxes, by AGI Class, 1980.

Size of AGI (\$1,000s)	(1) Weighted Average Marginal Tax Rate for Itemizers a/	(2) Percent of All Returns Itemizing State-Local Taxes b/
Total	36 %	30.6 %
Under 5	0	1.8
5-10	17	7.0
10-15	19	17.9
15-20	22	32.2
20-25	26	50.8
25-30	29	65.0
30-50	33	81.6
50-100	50	93.3
100-200	60	96.0
200-500	70	97.9
500-1,000	70	98.8
1,000+	70	99.1

a/ Calculated by CRS as follows: Marginal tax rates for both joint and single returns were assigned by CRS to IRS tabulations (unpublished) of average taxable income of itemizers by AGI class for 1980. The weighted marginal tax rate for the AGI class was calculated as the sum of the marginal tax rate for joint returns multiplied times the percent of joint returns in the AGI class, plus the marginal rate for single returns times the percent of nonjoint returns in the AGI class. See appendix table A.2 for the percent of joint returns by AGI class.

Unfortunately, data are not available for 1980 on the breakdown of itemized returns alone by marital status by AGI class. Using the breakdown for all returns tends to overestimate the average marginal tax rate overall. Note that the weighted tax rate calculated for the U.S. total is 36, compared to the rate of 34 derived from the Treasury Department's tax model. This upward bias occurs because joint returns represent a lower proportion of all returns (48.2 percent in 1980) than of itemized returns (76.3 percent in 1980). Thus, using the percentage weights based on all returns tends to underrepresent joint returns--the marital status class which is taxed at the lowest marginal rate for a given level of taxable income. The consistency of the U.S. average marginal tax rates was sacrificed here in order to reflect the differences among AGI classes in the percent of returns that are joint returns. See footnote 35 for further detail.

b/ Calculated by CRS from data presented in appendix table A.1: column 3, the number of returns deducting State-local taxes of any kind, divided by column 2, the number of all returns, by AGI class.

dollar lost in deductions means a greater absolute dollar increase in Federal tax liability for higher compared with lower income groups.

Under all four of the proposals being examined, most itemizers would experience a partial loss of the deductions that they now can claim for the State and local taxes they pay. The major source of difference among the proposals is how that loss of deductions would be distributed among taxpayers.

Table 4 compares among AGI classes the amount of State-local tax deductions actually claimed by itemizers in tax year 1980. Column 1 presents the average dollar size of the State-local taxes-paid deduction on returns itemizing that deduction. This can be interpreted as the average amount of the deductible taxes paid by an itemizer in the AGI class. Perhaps not surprisingly, the absolute dollar amount deducted increases with income.

Column 2 expresses the amount of State-local taxes deducted as a percent of itemizers' AGI. It suggests that these deductible State-local taxes represent a surprisingly similar proportion of income for itemizers in the middle and upper income classes, staying within a relatively narrow band from 7.8 percent in the \$15,000 to \$20,000 AGI class to 7.0 percent in the \$500,000 to \$1,000,000 AGI class, but a higher percentage for itemizers in income classes below \$15,000.

Column 3 looks at the amount of sales tax deductions claimed, also as a percentage of itemizers' AGI. Compared with the measure for all S-L taxes, this percentage declines at a steeper rate across all the income classes, from 3.6 percent in the under-\$5,000 class, to 0.2 percent in the over-\$1,000,000 class.

CRS estimates of the expected loss of deductions for an individual itemizer by AGI class under each of the four proposals are presented in appendix table A.3. In 1980 dollars, the average loss of deductions for all itemizers ranges from \$320 for the one percent of AGI floor proposal, to \$418 for the fixed dollar floor proposal. (This disparity reflects in part the fact that the proposals are not revenue-equivalent in the aggregate.) Compared to the

TABLE 4. State-Local Tax Deductions: Average Size and Relationship to Adjusted Gross Income, by AGI Class, 1980.

Size of AGI (\$1,000s)	(1) Average State- Local Taxes Paid Deductions per Itemizer	(2) State-Local Taxes Deducted as a Percent of Itemizers' AGI	(3) Sales Tax Deductions as a Percent of Itemizers' AGI
Total	\$ 2,414	7.5 %	1.2 %
Under 5	600	15.6	3.6
5-10	907	11.2	2.2
10-15	1,118	8.8	1.9
15-20	1,376	7.8	1.6
20-25	1,718	7.6	1.4
25-30	1,997	7.3	1.3
30-50	2,725	7.3	1.2
50-100	4,857	7.5	1.0
100-200	9,651	7.3	.7
200-500	20,235	7.2	.4
500-1,000	46,896	7.0	.3
1,000+	155,612	7.5	.2

a/ Total dollar amount of State-local taxes deducted divided by the number of returns itemizing State-local taxes.

b/ Total dollar amount of State-local taxes deducted divided by AGI for all itemized returns.

c/ Deductions for State-local general sales taxes divided by AGI for all itemized returns.

Source: Calculated by CRS from data presented in: Internal Revenue Service. Statistics of Income--1980, Individual Income Tax Returns. Washington, D.C.: U.S. Govt. Print. Off., 1982. Publication 79 (9-82). (Elsewhere referred to as 1980 SOI.) Table 2.1, p. 56.

average actual State-local taxes-paid deduction of \$2,414 in 1980, this represents a loss of approximately 13 to 17 percent of currently eligible deductions for itemizers overall. ^{32/} The percentage of deductions lost by a specific income group could differ considerably, depending upon which limitation proposal was adopted.

These differences by income class are reflected in the traditional evaluation of progressivity which focuses on the increase in tax liability relative to income. The increase in tax liability was estimated by multiplying the expected loss of deductions, from appendix table A.3, by the weighted average marginal tax rate, from column 1 of table 3.

Figures 1 and 2 illustrate the results of two progressivity calculations comparing the four proposals, for adjusted gross income classes from \$5,000 to \$200,000. ^{33/} They represent the expected increase in tax liability as a percent of AGI that would have occurred as of 1980. The statistics underlying the graphs are presented in appendix A.

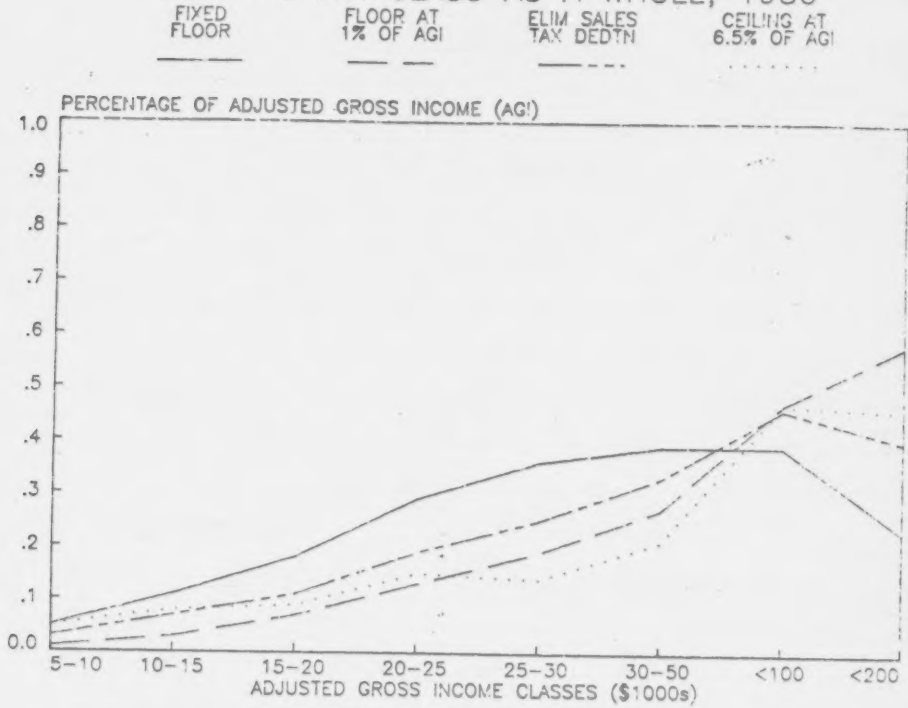
^{32/} This percentage range is comparable to the ratio that the projected revenue gains of around \$6 billion from the alternative deductibility-limitation proposals (presented in table 2) hold to the Joint Committee on Taxation's March 1983 estimates of the total tax expenditure revenue cost of the current provisions for the deductibility of State and local taxes for FYs 1984 through 1988. Those tax expenditure estimates are as follows: FY85, \$37,085 million; FY86, \$41,680 million; FY87, \$47,340 million; and FY88, \$53,990 million.

Tax expenditure estimates for all State and local tax deductions were calculated by CRS by adding the JCT estimates for the deductibility of property taxes on owner-occupied homes and for the deductibility of nonbusiness State and local government taxes other than on owner-occupied homes, as presented in: U.S. Congress. Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988. Prepared for the Committee on Ways and Means and the Committee on Finance. March 7, 1983. p. 13, 17.

^{33/} AGI below \$5,000 was considered nontaxable for examples including joint returns, with a zero bracket amount of \$3,400 and personal exemptions of \$1,000 each. AGI classes above \$200,000 account for only a small fraction of all tax returns.

FIGURE 1

INCREASE IN TAX LIABILITY AS A PERCENT OF AGI
FOR THE AGI CLASS AS A WHOLE, 1980



Source: See Appendix, table A.6.

Figure 1 presents the expected increase in tax liability as a percent of AGI for the AGI class as a whole, the most common measure of tax progressivity. ^{34/} Figure 2 presents the same estimated increase in tax liability by AGI class for 1980, but this time as a percent of AGI for itemizers alone (the percent increase for an individual itemizer is equivalent to the percentage increase for itemizers as a group). The essential difference between the two figures is that the statistics illustrated in figure 1 take into account the proportion of itemizers in each AGI class and the size of the AGI class in terms of total AGI. This weighting tends to make all of the proposals look more progressive.

In interpreting figure 1, generally the more upward-sloping the line that represents a proposal, the more progressive the proposal can be considered. Oppositely, the more downward-sloping its line, the more regressive a proposal can be considered. It should be noted that the magnitude of the numbers involved is small. For every example, the expected increase in tax liability is less than one percent of AGI.

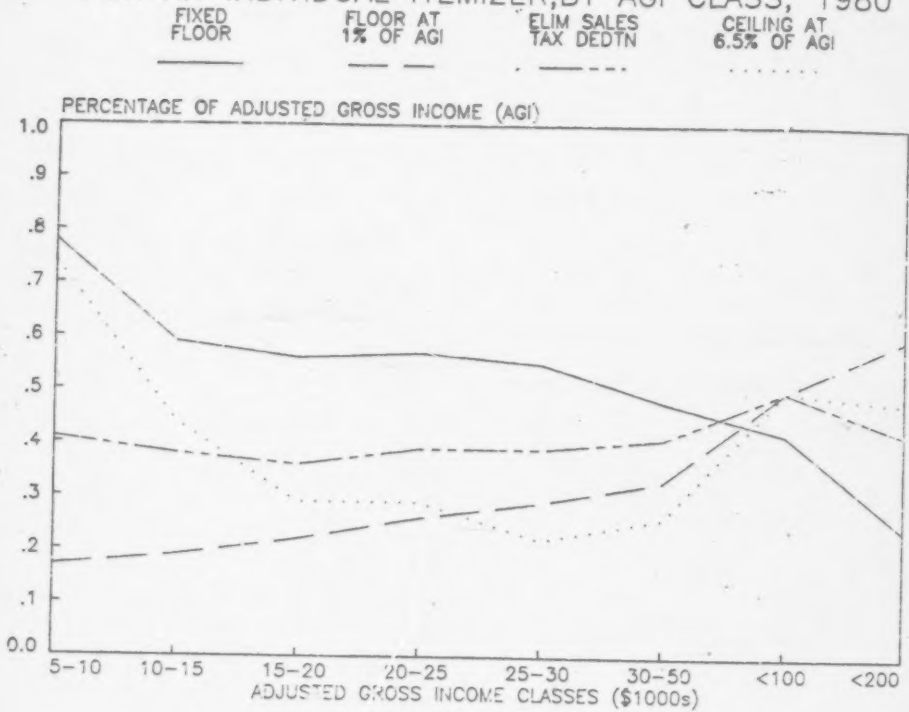
The most regressive of the four proposals is the fixed dollar floor. It raises tax liabilities on income groups below \$50,000 (1980 dollars) more and on income groups above \$50,000 less than the other three proposals. In direct contrast, the most progressive of the four proposals is the variable floor, set at one percent of AGI. This is the proposal which shows an increase in tax liability that increases most consistently with income.

The proposal which appears most proportional, in the sense of levying the most nearly similar increase in tax liability as a percent of income across

^{34/} Another set of calculations was made using the more refined concept of after-tax AGI as the basis of comparison. The pattern of results was similar to that using AGI shown in figure 1, though the measure of increased tax liability was somewhat higher, particularly for higher income groups, since after-tax AGI represents a smaller fraction of AGI the higher the income class.

FIGURE 2

INCREASE IN TAX LIABILITY AS A PERCENT OF AGI FOR AN INDIVIDUAL ITEMIZER, BY AGI CLASS, 1980



Source: See Appendix, table A.5.

the income classes (as depicted by the line which appears most horizontal relative to the others) is eliminating the deductibility of the sales tax.

The proposal to impose a ceiling at 6.5 percent of AGI produces a U-shaped pattern of increase in tax liabilities. Relative to the one percent of AGI floor and the sales tax proposals, the increase in tax liability is higher for the income groups below \$25,000, dips below for the \$25,000 to \$50,000 group, rises above for the \$50,000 to \$100,000 group, and levels off above \$100,000.

Figure 2 illustrates that the patterns just described are magnified when the effects are examined for itemizers alone. Again, the fixed dollar floor appears most regressive, eliminating the sales tax appears most proportional, the ceiling as a percent of AGI appears U-shaped, and the percent of AGI floor appears most progressive—all when viewed on a nationwide aggregate basis.

E. Variation in the Effect of the Alternative Proposals among the States

In selecting among alternative proposals for limiting the Federal deduction for State and local taxes, an important criterion might be equitable treatment among the States. Noteworthy differences in the likely distribution of the increased Federal tax burden from the alternative deductibility-limitation proposals are revealed when the proposals are examined on a State-by-State basis. These differences stem from the considerable variation among the States in the relative dependence on the sales tax as a S-L revenue source and in the level of S-L taxation relative to taxpayers' income.

This section presents estimates of the aggregate increase in tax liability by State, and statistically compares the variation in added tax burden among the States for two of the alternative proposals—eliminating the deductibility of the sales tax and imposing a floor at one percent of AGI. The section also presents figures which illustrate why imposing a ceiling at 6.5 percent of AGI could be expected to have an unacceptably different effect between high-tax and low-tax States; imposing a one percent of AGI floor, in contrast, would be the most

even-handed alternative in distributing the increased Federal tax burden among taxpayers in all States. Because the fixed dollar floor approach was found to be the most regressive alternative when viewed nationwide, it was not examined further on a State-by-State basis.

As with the calculations by income class, a certain portion of the variation in the expected tax increase among the States is the result of differences in the percent of their tax filers who are itemizers, and in the average taxable income levels and, therefore, the corresponding average marginal tax rates of those itemizers. Any dollar lost in eligible deductions is likely to mean a greater increase in tax liability relative to the income of individuals in the State as a whole, the higher the fraction of taxpayers who are itemizers and the higher their marginal tax rate.

Column 1 of table 5 lists by State the percent of Federal tax returns that itemized State and local taxes of some kind for tax year 1980. Nationwide, the figure was 30.5 percent of all returns. Among the States, however, this measure ranged from a low of 16.4 percent in West Virginia to a high of 41.3 percent in Utah.

Column 2 of table 5 lists the marginal tax rates for joint returns in 1980 which correspond to the average taxable income of itemizers by State. ^{35/} The

^{35/} Relying on joint-return rates, rather than calculating weighted marginal tax rates, is based on the information that, when all income classes are considered together, joint returns are by far the dominant type of itemized return. Nationwide, for 1980, 76.3 percent of itemized returns were joint returns of husbands and wives, compared with 48.2 percent of all returns being joint returns. Of the remaining itemized returns, 0.1 percent were for surviving spouses, 1.7 percent separate returns of husbands and wives, 6.0 percent heads of households, and 15.9 percent single persons. (Variations among the States in the percent of itemized returns in each of the filing classes should be taken into account in calculating weighted tax rates by State.) Percent of returns by filing status calculated by CRS from 1980 SOI, table 2.2 on p. 58-59 for itemized returns, and table 1.2 on p. 39-40 for all returns.

Use of the joint return rate will somewhat understate the expected increase in tax liability, since the rates paid by the other filing classes on a given level of taxable income are higher (with the exception of surviving spouses who are taxed at the joint-return rate). Note that the joint return rate assigned to the U.S. total is 32, compared to the overall rate of 34 derived from the Treasury Department's tax model and used for the nationwide aggregate estimates in chapters II and VI, and compared to the weighted overall rate of 36 presented in table 3.

TABLE 5
Limiting Deductibility: Underlying Factors Influencing
The Increase in Federal Tax Liability by State, 1980

	(1)	(2)	(3)	(4)
	Percent Itemizers	Itemizers' Marginal Tax Rate	Average AGI of All Tax Filers	Average AGI of Itemizers
	%	%	\$	\$
ALABAMA	30.4	20	15374	27809
ALASKA	33.3	37	22363	47187
ARIZONA	37.3	20	16436	26368
ARKANSAS	22.3	20	13674	27330
CALIFORNIA	36.0	20	18322	32673
COLORADO	39.5	20	17591	30805
CONNECTICUT	30.4	37	19437	35479
DELAWARE	31.6	32	18233	36047
DIST. COLUMBIA	33.0	32	18153	35462
FLORIDA	24.2	32	16142	30751
GEORGIA	28.3	20	15506	31891
HAWAII	37.2	20	17258	30680
IDaho	31.2	20	15218	27686
ILLINOIS	32.1	32	18631	34319
INDIANA	25.4	20	16894	31305
IOWA	30.0	20	16688	31625
KANSAS	27.1	32	17054	35495
KENTUCKY	26.7	20	15233	31193
LOUISIANA	23.3	20	16624	32179
MAINE	20.6	20	13802	27281
MARYLAND	37.2	20	18393	35375
MASSACHUSETTS	33.3	20	16969	31631
MICHIGAN	38.1	32	18224	34860
MINNESOTA	35.8	20	17077	32095
MISSISSIPPI	22.6	20	13929	30905
MISSOURI	27.3	20	16288	30781
MONTANA	29.6	20	15082	27087
NEBRASKA	26.0	20	15824	30718
NEVADA	30.1	20	17229	31432
NEW HAMPSHIRE	23.2	32	16368	29406
NEW JERSEY	31.6	32	18752	34860
NEW MEXICO	25.0	20	14963	28111
NEW YORK	36.0	20	18098	33132
NORTH CAROLINA	25.4	20	14743	30726
NORTH DAKOTA	21.7	20	14696	30526
OHIO	27.0	20	17059	31405
OKLAHOMA	28.4	32	16829	30996
OREGON	35.2	20	16421	29756
PENNSYLVANIA	26.6	32	16755	31998
RHODE ISLAND	26.0	20	15716	31248
SOUTH CAROLINA	29.3	20	14647	27143
SOUTH DAKOTA	17.2	20	13427	26240
TENNESSEE	20.1	20	15096	32428
TEXAS	21.9	37	17785	37110
UTAH	41.3	24	16230	28064
VERMONT	21.3	20	14478	28407
VIRGINIA	31.6	20	17418	32842
WASHINGTON	30.4	20	18293	31454
WEST VIRGINIA	16.4	32	16156	31165
WISCONSIN	34.0	20	16637	30328
WYOMING	26.9	20	18769	32741
US TOTAL	30.5	32	17185	32442

Sources: See next page

Sources of table 5, listed by column number:

- (1) Data on number of returns with itemized deductions for State and local taxes, by State for 1980, from an unpublished Internal Revenue Service (IRS) tabulation; divided by total number of returns by State, from 1980 SOI, table 4.1 on p. 93.
- (2) CRS assigned the Federal marginal tax rate for joint returns in 1980 corresponding to the average taxable income of itemizers by State for 1980, obtained from an unpublished IRS tabulation.
- (3) The average AGI for all tax filers was calculated by CRS from data on aggregate adjusted gross income (AGI) and number of returns by State from 1980 SOI, table 4.1 on p. 93.
- (4) IRS data by State on AGI for itemizers was available for 1979 but not 1980. See: Statistics of Income--1979, Individual Income Tax Returns, table 5.2 on p. 119.

CRS inflated the 1979 data to 1980 levels by multiplying the 1979 data for each State on aggregate AGI for itemizers, times the ratio of nationwide aggregate AGI data for itemizers in 1980 relative to 1979, from 1980 SOI, table 2.1 on p. 56; and 1979 SOI, table 2.1 on p. 35. This approximation does not account for the possibility of differing rates of growth in itemizers' AGI among the States between 1979 and 1980.

To approximate the average AGI per itemizer, the estimated aggregate AGI for itemizers was divided by the number of returns itemizing State and local taxes.

rate nationwide was 32 percent. Among the States the applicable tax rates ranged from 24 to 37 percent.

Table 5 also documents how much income levels vary among the States. The average AGI for all tax filers is presented in column 3, and for itemizers only in column 4. The average income of itemizers is seen to be considerably higher than that for all tax filers. The average AGI of all tax filers was \$17,185 nationwide, and ranged from a low of \$13,427 in South Dakota, to a high of \$22,363 in Alaska. The estimated average AGI of itemizers was \$32,442 nationwide, and ranged from a low of \$27,087 in Montana, to a high of \$47,187 in Alaska. ^{36/}

Table 6 illustrates the variation among the States in the expected increase in tax liability from the proposal to eliminate the deductibility of the sales tax. This variation stems in large part from the substantial differences among the States in dependence on the general sales tax as a State-local revenue source. This relative dependence is reflected in the percentage that sales taxes represent of all State and local tax deductions claimed by itemizers in the State, shown for tax year 1980 in column 1 of table 6. Nationwide, sales taxes account for 15.9 percent of all State-local tax deductions, but this ranges from a low of 0.6 percent in Oregon, to a high of 46.3 percent in Louisiana. ^{37/}

Column 2 of table 6 reports the amount of sales tax deductions claimed on all itemized returns from the State in 1980. This represents the total amount of deductions that would have been lost by taxpayers in the State if the deductibility of the sales tax had not been permitted in 1980. This

^{36/} CRS estimated 1980 AGI for itemizers by State according to a method explained in source note 4 of table 5.

^{37/} Residents of States which have no sales tax--Alaska, Delaware, Montana, New Hampshire, and Oregon--can still deduct sales taxes they pay to States other than their own.

TABLE 6
Eliminating Sales Tax Deductibility: The
Increase in Federal Tax Liability by State, 1980 Basis

	(1)	(2)	(3)	(4)	(5)
	Sales Tax Deductions as Percent of Total State-Local Tax Deductions	Total Sales Tax Deductions	Increase in Federal Tax Liability Per Capita	Increase in Federal Tax as a Percent of:	
	%	\$ mill.	\$	Total AGI	Itemizers AGI
ALABAMA	29.4	193.2	13.91	.25	.46
ALASKA	12.0	11.7	10.02	.11	.15
ARIZONA	24.9	102.2	18.77	.20	.43
ARKANSAS	16.8	50.3	6.16	.12	.28
CALIFORNIA	17.6	1930.4	22.04	.29	.42
COLORADO	18.3	200.3	19.41	.25	.36
CONNECTICUT	19.7	213.4	25.40	.28	.51
DELAWARE	1.3	3.0	1.61	.02	.03
DIST. COLUMBIA	9.4	30.9	15.50	.18	.27
FLORIDA	26.6	313.9	10.31	.15	.32
GEORGIA	16.7	203.2	10.41	.17	.30
HAWAII	16.4	72.1	20.92	.20	.42
IDAHO	12.9	29.0	8.60	.15	.26
ILLINOIS	21.2	723.3	20.27	.26	.43
INDIANA	22.4	186.2	9.50	.14	.30
IOWA	11.5	87.4	8.40	.12	.22
KANSAS	15.6	82.3	11.15	.16	.27
KENTUCKY	16.0	121.3	9.20	.17	.31
LOUISIANA	46.3	169.3	11.20	.18	.40
MAINE	14.4	31.2	7.77	.14	.34
MARYLAND	11.5	251.5	16.70	.20	.28
MASSACHUSETTS	7.9	224.5	10.96	.15	.24
MICHIGAN	11.3	452.4	15.64	.22	.30
MINNESOTA	8.5	150.0	10.91	.15	.22
MISSISSIPPI	30.3	80.9	9.87	.21	.41
MISSOURI	20.4	196.9	11.21	.17	.33
MONTANA	1.1	1.9	.68	.01	.02
NEBRASKA	15.0	60.7	10.03	.16	.32
NEVADA	26.6	33.2	11.63	.14	.25
NEW HAMPSHIRE	2.1	3.8	1.32	.02	.04
NEW JERSEY	12.2	369.3	16.05	.19	.32
NEW MEXICO	20.0	55.9	12.04	.20	.43
NEW YORK	13.6	1452.2	23.16	.31	.47
NORTH CAROLINA	13.9	102.7	8.71	.15	.28
NORTH DAKOTA	15.0	13.1	5.62	.09	.20
OHIO	16.0	354.0	9.10	.13	.26
OKLAHOMA	19.1	106.6	11.20	.17	.33
OREGON	.6	5.6	.60	.01	.01
PENNSYLVANIA	13.9	419.6	11.31	.17	.33
RHODE ISLAND	12.3	37.1	10.97	.16	.31
SOUTH CAROLINA	17.4	116.0	10.49	.19	.35
SOUTH DAKOTA	30.9	20.9	8.40	.16	.43
TENNESSEE	46.0	104.6	11.26	.19	.45
TEXAS	32.0	495.2	12.60	.18	.39
UTAH	20.5	95.7	15.72	.26	.37
VERMONT	6.0	8.1	4.44	.07	.18
VIRGINIA	13.3	229.1	12.00	.17	.28
WASHINGTON	36.0	251.0	17.02	.21	.41
WEST VIRGINIA	16.4	29.8	4.09	.09	.28
WISCONSIN	9.7	200.3	11.92	.17	.28
WYOMING	45.0	23.1	13.73	.16	.35
US TOTAL	15.9	10972.4	15.50	.22	.38

Sources: See next page

Sources of table 6, listed by column number:

- (1) Percentage calculated by CRS from data on deductions by type of State-local tax by State for tax year 1980 obtained from an unpublished IRS tabulation.

Appendix table B.1 reports for each State the percentage breakdown of total State-local tax deductions claimed in 1980 among the four major taxes eligible for deduction: sales, income, real estate, and personal property.

- (2) Unpublished IRS tabulation of actual sales tax deductions by State for tax year 1980.
- (3) Calculated by CRS as follows: The estimated total increase in tax liability for the State's taxpayers as a group is equal to the marginal tax rate (column 2 of table 5) times the loss of sales tax deductions (column 2 of table 6). To get a per capita figure, the State aggregate increase in tax liability was divided by the 1980 population of the State from: U.S. Bureau of the Census. Governmental Finances, 1979-80. Washington, U.S. Govt. Print. Off., 1981. Table 27, p. 95.

Appendix table B.2 reports by State the average dollar amount deducted per return itemizing sales, income, real estate, and personal property taxes for tax year 1980.

- (4) Calculated by CRS as the estimated increase in tax liability for the State, divided by the aggregate AGI for the State on 1980 tax returns, from 1980 SOI, table 4.1 on p. 93.
- (5) Calculated by CRS as the estimated increase in tax liability for the State, divided by the estimate of aggregate AGI for itemizers in the State for 1980, explained in source note 4 of table 5.

figure was multiplied by the average marginal tax rate from column 2 of table 5 in order to estimate the expected increase in Federal tax liability for taxpayers in the State as a whole.

Table 7 presents comparable calculations of the increase in tax liability by State for the one percent of AGI floor proposal. Column 2 of table 7 equals one percent of the estimated AGI of all itemizers in the State for 1980. This again represents the amount of deductions that would have been disallowed if that limitation had been imposed on State-local tax deductions in 1980.

Because the States differ so much in level of income (as documented in columns 3 and 4 of table 5) and in population size, it is difficult to make comparisons among estimates of the aggregate increase in tax liability for each State taken as a whole. To facilitate interstate comparisons, in both table 6 and table 7, column 3 expresses each State's estimated increase in Federal tax liability on a per capita basis; column 4 expresses the increase in tax liability as a percentage of total AGI for all tax filers in the State; and column 5 as a percent of AGI for only itemizers in the State.

According to column 3 of table 6, the estimated increase in Federal tax liability per capita from eliminating the deductibility of the sales tax is \$15.50 nationwide, ranging from \$.60 in Oregon, to \$25.40 in Connecticut. According to column 4, as a percent of total AGI, the increase in tax liability is .22 percent nationwide, ranging from .01 percent in Oregon and Montana, to .31 percent in New York. According to column 5, as a percent of AGI for itemizers only, the increase in tax liability is .38 percent nationwide, ranging from a low of .01 percent in Oregon, to a high of .51 percent in Connecticut.

According to column 3 of table 7, the estimated increase in Federal tax liability per capita from imposing a one percent of AGI floor on all State-local tax deductions is \$13.11 nationwide, ranging from \$5.48 in South Dakota to

TABLE 7
Limiting Tax Deductibility as a Percent of AGI: The
Increase in Federal Tax Liability by State, 1980 Basis

	(1)	(2)	(3)	(4)	(5)
	Total S-L				
	Taxes Deducted as Percent of Itemizers' AGI	One Percent of Itemizers' AGI	Increase in Federal Tax Per Capita	Increase in Federal Tax as Percent of:	
	%	\$ mill.	\$	% Total AGI	% Itemizers' AGI
ALABAMA	5.6	117.97	8.49	.15	.28
ALASKA	3.4	28.78	26.63	.26	.37
ARIZONA	6.2	117.73	12.13	.18	.28
ARKANSAS	6.1	49.44	6.86	.12	.28
CALIFORNIA	8.5	1284.15	15.19	.19	.28
COLORADO	6.9	157.79	15.29	.19	.28
CONNECTICUT	7.0	155.88	18.46	.21	.37
DELAWARE	7.9	28.87	15.53	.20	.32
DIST. COLUMBIA	9.2	35.98	18.05	.21	.32
FLORIDA	3.8	389.79	10.18	.15	.32
GEORGIA	6.3	192.15	9.85	.16	.28
HAWAII	9.1	48.35	14.03	.18	.28
IDAHO	7.3	38.95	9.18	.16	.28
ILLINOIS	6.4	532.63	14.93	.19	.32
INDIANA	4.7	175.25	8.94	.13	.28
IOWA	6.7	112.93	10.86	.16	.28
KANSAS	5.5	95.80	12.97	.18	.32
KENTUCKY	6.6	108.83	8.32	.15	.28
LOUISIANA	3.1	118.23	7.87	.12	.28
MAINE	8.4	25.86	6.44	.11	.28
MARYLAND	8.8	247.18	16.41	.20	.28
MASSACHUSETTS	10.6	267.44	13.85	.17	.28
MICHIGAN	8.2	487.38	16.84	.23	.32
MINNESOTA	9.3	199.99	13.73	.19	.28
MISSISSIPPI	4.9	68.23	6.69	.14	.28
MISSOURI	5.8	165.85	9.44	.14	.28
MONTANA	6.5	26.55	9.44	.15	.28
NEBRASKA	7.6	52.83	9.42	.14	.28
NEVADA	3.4	37.28	13.86	.15	.28
NEW HAMPSHIRE	6.5	28.17	9.79	.13	.32
NEW JERSEY	8.2	369.98	16.87	.19	.32
NEW MEXICO	5.5	36.49	7.86	.13	.28
NEW YORK	12.2	872.81	13.91	.19	.28
NORTH CAROLINA	7.2	182.67	8.71	.15	.28
NORTH DAKOTA	4.6	17.95	7.70	.13	.28
OHIO	5.8	388.57	9.87	.14	.28
OKLAHOMA	5.4	184.33	11.84	.17	.32
OREGON	8.4	118.28	12.58	.18	.28
PENNSYLVANIA	7.3	412.26	11.12	.16	.32
RHODE ISLAND	9.1	33.83	9.77	.14	.28
SOUTH CAROLINA	7.1	94.21	8.46	.15	.28
SOUTH DAKOTA	5.8	13.58	5.48	.10	.28
TENNESSEE	3.5	114.63	6.99	.12	.28
TEXAS	2.2	475.26	12.36	.17	.37
UTAH	7.5	62.58	18.27	.17	.24
VERMONT	9.4	12.73	6.97	.12	.28
VIRGINIA	7.4	231.27	12.11	.17	.28
WASHINGTON	4.8	171.20	11.61	.15	.28
WEST VIRGINIA	5.3	34.53	5.67	.10	.32
WISCONSIN	10.2	282.77	12.87	.17	.28
WYOMING	2.7	18.56	11.84	.13	.28
US TOTAL	7.4	9276.59	13.11	.18	.32

Sources: See next page

Sources of table 7, listed by column number:

- (1) Percentage calculated by CRS from data on deductions for State-local taxes by State for tax year 1980, from an unpublished IRS tabulation, divided by the CRS estimate of itemizers' AGI in 1980, explained in source note 4 of table 5.
- (2) One percent of the CRS estimate of aggregate AGI for itemizers in the State in 1980.
- (3) Calculated by CRS as follows: The estimated total increase in tax liability for the State's taxpayers as a group is equal to the marginal tax rate (column 2 of table 5), times the loss of deductions by the amount of one percent of AGI for itemizers (column 2 of table 7). To get a per capita figure, the State aggregate increase in tax liability was divided by the 1980 population of the State, from Governmental Finances, 1979-80, table 27 on p. 95.
- (4) Calculated by CRS as the estimated increase in tax liability for the State, divided by the aggregate AGI for the State on 1980 tax returns, from 1980 SOI, table 4.1 on p. 93.
- (5) Calculated by CRS as the estimated increase in tax liability for the State, divided by the estimate of aggregate AGI for itemizers in the State in 1980, explained in source note 4 of table 5.

\$26.63 in Alaska. According to column 4, the increase in tax liability as a percent of total AGI is 0.18 percent nationwide, ranging from 0.10 percent in South Dakota and West Virginia, to 0.26 percent in Alaska. The increase in tax liability as a percent of itemizers' AGI is equivalent to one percent of the marginal tax rate used in the calculation; this is 0.32 percent nationwide, ranging from a low of 0.24 percent in Utah, to a high of 0.37 percent in Alaska, Connecticut, and Texas. (The increase in tax liability as a percent of total AGI, presented in column 4, directly reflects the combined effects of the marginal tax rate and the percent of itemizers.)

Comparing the U.S. totals between tables 6 and 7 is a reminder that the two proposals were not expected to be revenue-equivalent. Table 2, presented at the beginning of this chapter, indicated that the one percent of AGI floor proposal was not expected to generate as much additional Federal revenue as repealing the sales tax deduction.

In order to get a measure of comparison which standardizes for the difference in dollar levels, a statistic called the coefficient of variation was calculated for the percentages reported in column 4 of tables 6 and 7--the increase in Federal tax as a percent of total AGI for all taxpayers in the State. ^{38/} The coefficient of variation for the proposal to eliminate the deductibility of the sales tax was 0.39, larger than the coefficient of 0.22 for the proposal to impose a one percent of AGI floor. This indicates that the sales tax proposal is expected to distribute the increased Federal tax burden more unevenly among the States than the one percent of AGI proposal.

The one percent of AGI proposal also turns out to be much more uniform in its expected effect among the States than the proposal to impose a ceiling on

^{38/} The coefficient of variation is equal to the standard deviation divided by the mean (average).

all State-local tax deductions at 6.5 percent of AGI. Recall that when viewed on a nationwide basis across income classes, State-local tax deductions as a percentage of income fell within a relatively narrow range around a U.S. average of 7.5 percent. When viewed on a State-by-State basis, however, the range of variation is far greater. Column 1 of table 7 shows that 1980 tax deductions as a percent of estimated itemizers' AGI for 1980 ranged from a low of 2.7 percent in Wyoming, to a high of 12.2 percent in New York, compared to a U.S. average of 7.4 percent. ^{39/}

The existence of wide variations in tax burdens among States is corroborated by the Advisory Commission on Intergovernmental Relations' (ACIR) estimates of State-local tax burdens for a hypothetical family of four in the largest city in each State in 1980, reproduced as appendix table B.3 of this report. ACIR estimated the combined burden of State-local property, personal income, and general sales taxes as a percent of income (the median income reported by FHA-insured mortgagors) to range from a low of 2.0 percent in New Orleans, to a high of 11.8 percent for New York City, with a value for the median city of 5.8 percent.

For 1980, then, according to column 1 of table 7, State-local tax deductions exceeded the proposed floor of one or 1.5 percent of itemizers' AGI for all States. For 26 States, these deductions also exceeded the proposed ceiling of 6.5 percent of itemizers' AGI. But for 25 States, State-local tax deductions fell at or below 6.5 percent of itemizers' AGI.

^{39/} The denominator in this calculation--aggregate AGI for itemizers in the State--is an estimate made for 1980, by a method explained in source note 4 of table 5. As a result, the estimated percentages presented in column 1 of table 7 may slightly understate the actual percentage that tax deductions were of itemizers' AGI in 1980 in States where itemizers' AGI outpaced the national average between 1979 and 1980, and overstate the actual percentage in States where itemizers' AGI growth was below the national average.

These statistics on State-local taxes as a percentage of itemizers' AGI suggest that if a floor of one or 1.5 percent of AGI were imposed, essentially all itemizers in all States would lose deductions of that amount. In contrast, if a ceiling were imposed, at 6.5 percent of AGI for example, it is likely that most itemizers in low tax-burden States would not experience a curtailment in eligible deductions, while most itemizers in high-tax States would experience a loss of deductions and consequent increase in Federal tax liability. This reasoning leads to the conclusion that setting a floor as a percentage of AGI-- at a level that lies below the average tax burden of even the lowest-tax State-- is the alternative that appears most even-handed in distributing the increase in Federal tax liability among taxpayers in all States.

VI. AN EVALUATION OF A SPECIFIC PROPOSAL TO EXCHANGE A PARTIAL LIMITATION OF STATE-LOCAL TAX DEDUCTIBILITY FOR AN INCREASE IN GENERAL REVENUE SHARING

As indicated in chapter I, proposals to limit the deductibility of State and local taxes under the Federal individual income tax are being discussed in a variety of contexts, including revenue-raising, tax-base broadening, and flat-rate tax proposals. The specific proposal analyzed in this chapter seeks Federalism reforms by financing an increase in the general revenue sharing (GRS) program with revenue raised by limiting the deductibility of State and local taxes.

Two of the deduction-limitation proposals are considered here in detail:

- 1) setting a floor on deductions of State-local taxes at one percent of AGI; and
- 2) eliminating the deductibility of sales taxes. This chapter explains the Congressional Research Service's estimates of the expected net effects of these proposals, in both the short and the long run, on the budgets of the three main parties involved--taxpayers, the Federal Government, and State-local sector. ^{40/}

^{40/} Based on 1958 data, Benjamin Bridges conducted a similar analysis of several other alternatives to the State-local tax deductibility provision--including removing all deductibility, removing deductibility of all State-local taxes other than income taxes, imposing a floor at three percent of AGI, replacing deductibility with a credit of a certain percent of all deductible taxes, and replacing deductibility with a credit for 100 percent of State income tax up to a constant percent or sliding-scale percent of Federal income taxes. He traced the implications for Federal revenues, tax progressivity, State-local revenues on a State-by-State basis, and interstate income tax differentials. As a more effective means of aiding State and local governments, Bridges concluded in favor of replacing deductibility with a credit for State income taxes and/or a program of unconditional Federal grants.

See: Benjamin Bridges, Jr. Allowances for State and Local Nonbusiness Taxes [in] Richard A. Musgrave, ed. *Essays in Fiscal Federalism*. Washington, D.C.: The Brookings Institution, 1965. p. 187-234.

A. Questions Raised by the Proposal

The proposal being examined would increase the appropriations for general revenue sharing (GRS) by \$6 billion, as of FY 1985. In order to partially finance this \$6 billion, the proposal would limit the Internal Revenue Code provisions which permit the deduction of State and local taxes so as to raise additional revenue from the individual income tax.

The three response measures of particular concern to this analysis are:

- 1) the extent to which the loss of Federal tax deductions reduces taxpayers' willingness to pay State and local taxes and thereby reduces S-L own-source revenue;
- 2) the extent to which S-L governments' short-run response to additional GRS funds is to increase spending rather than provide tax relief;
- 3) the extent to which this division between spending and tax relief changes over the long run.

B. Caveats Regarding the Numerical Estimates

A few caveats are in order at the outset. First, the numerical estimates are based on statistical parameters drawn from a variety of empirical studies conducted by other researchers who were examining the effects of Federal grants on State and local expenditure behavior during the 1970s. This was a period when Federal intergovernmental aid was increasing and when the State-local sector's own fiscal condition was much healthier than it is now. The response of S-L governments to a change in Federal aid patterns might be quite different under the tighter fiscal conditions characteristic of the early 1980s.

Consequently, the numerical answers generated below should be regarded as rough best guesses rather than refined estimates. A special effort has been made to lay out the building blocks of the calculation so that the assumptions about the values of the parameters can be discussed, revised estimates of the

parameters can be substituted, and the sensitivity of the results to changes in these assumptions can be easily examined.

Second, the analysis proceeds from the assumption that itemizers--the people who would be directly affected by the proposal to limit the deductibility of State and local taxes--are the ones who dominate S-L fiscal decisions. This assumption may not be equally appropriate for all States and localities which can differ substantially in their revenue structure and in their residents' marginal Federal tax rates and likelihood of itemizing deductions, as was shown in chapter V. If, instead, nonitemizers and even nontaxpayers dominate S-L fiscal decisions, there may be less of a negative effect on S-L revenues than is suggested here. A more precise answer would require a more detailed analysis of the political strength of itemizers and the sensitivity of their behavior to changes in the tax laws.

Finally, this analysis does not consider any of the possible macroeconomic ramifications of the proposal. It examines only the initial shift in resources, which is expected to net an improvement in the Federal fiscal position. The analysis does not speculate on whether the Federal Government might raise expenditures, reduce debt, or reduce taxes in response, or on what the subsequent effects of alternative possibilities might be.

C. Organization of the Chapter

The remainder of this chapter is divided into three sections. Section D describes how the restriction of S-L tax deductibility can be expected to reduce S-L own-source revenue. The section emphasizes that, although the structure of the limitation proposal may not be particularly important to the Federal Government (since an equal revenue yield can be obtained either by disallowing deductions below some floor, by disallowing deductions above some ceiling, or by repealing the deductibility of certain taxes), the choice among the alternative

proposals is important to the S-L sector; this is because the economic incentives to S-L taxpayers created by the proposals differ and thereby generate different S-L revenue losses.

Section E calculates the net effects of a \$6 billion floor-limitation/GRS-increase proposal and a sales tax deduction elimination/GRS increase proposal on the budgets of the three parties involved: taxpayers (their after-tax incomes), the S-L sector, and the Federal Government. Calculations are made for two different time horizons: the short-run, during which the S-L sector does not have time to make budgetary decisions concerning the use of GRS funds; and a longer run, which allows time for the S-L sector to adjust and assimilate the increased GRS funds.

Based on IRS data for 1980, section F estimates and contrasts the potential own-source revenue loss for each of the States under the two deductibility-limitation proposals.

D. The Effect on State-Local Own-Source Revenues of Limiting the Deductibility of S-L Taxes from the Federal Individual Income Tax: Income and Price Effects in the Federal Offset

The question of particular interest here is how much taxpayers would cut their expenditures on State and local services--measured by payment of S-L taxes--in response to a limitation on the deductibility of State and local taxes. Will taxpayers tend to cut back expenditures on S-L services proportionately more than on other things--because they perceive that the restriction in the S-L tax deduction both decreases their after-tax income and also increases the price of public service consumption relative to the price of other goods and services? In this regard, an important point to be determined is whether the proposed deductibility limitations would have just an income effect, or a relative price or substitution effect as well.

For those itemizers affected, a limitation of eligible deductions implies an increase in Federal tax liability and an accompanying decrease in after-tax

income. Based on a nationwide average marginal tax rate applicable to the deduction of State and local taxes of .34, every dollar lost in S-L tax deductions would increase the average itemizer's Federal tax bill by \$.34; as a direct consequence their after-tax income would decline by \$.34. ^{41/} The proportion by which consumers are expected to change their expenditure for a particular item in response to a change in disposable income is known as the income effect. It has been estimated that taxpayers spend approximately .10 of income changes on S-L goods and services. ^{42/}

But, because this particular source of the change in income is a limitation on the deductibility of State and local taxes, it may be accompanied by the perception of an increase in the price of S-L activities relative to other goods and services. Consumers are generally expected to react to a change in relative prices by substituting away from items which have increased in price toward greater purchase of items which have decreased in price. According to the estimate derived in chapter II, the combined influence of the income and substitution effect, known as the price effect, on the consumption of S-L goods and services is .205 per dollar of change in after-tax income. This is twice the size of the income effect alone.

Whether there is a price effect or only an income effect would depend on how the limitation on the S-L tax deduction is designed—in particular, whether a ceiling, a floor, or the elimination of deductibility for a particular tax is adopted. A price effect would occur if limiting the S-L tax deduction would cause a change in the fraction of a dollar that the taxpayer perceives an

^{41/} See footnote 10 in chapter II. The value applicable to a specific taxpayer can run the whole range of marginal tax rates, from 14 to a maximum effective rate as of 1982 of 50 percent.

^{42/} See the reviews by Gramlich (1977) and Inman (1979) for discussions of the .10 estimate.

tional (marginal) dollar of State and local taxes will cost, net of the Federal offset. There will be only an income effect if the last dollar of S-L taxes will continue to be subsidized at the taxpayer's marginal tax rate. That is, an extra dollar of S-L taxes will continue to cost the taxpayer, net of Federal taxes, $\$(1-t)$, where t is the taxpayer's Federal marginal tax rate. Assuming a national average marginal tax rate of .34 for S-L tax deductions, the net price of the last dollar of S-L taxes was and would remain \$.66 even if the deduction were limited.

If a floor approach is adopted, and if the floor is set below the level of State-local tax deductions otherwise claimed by most itemizers, there would be only an income effect. Only those itemizers whose deductible S-L taxes lay completely below the floor would experience a price change.

If, in contrast, the approach taken were to place a ceiling on the amount of permissible deductions, with S-L tax payments over that amount receiving no Federal offset, and if the ceiling were set below the amount of deductions otherwise claimed by most itemizers, then there could be a substantial change in the net price to itemizers of an additional dollar of S-L taxes. While before the ceiling was placed on deduction the price had been $\$(1-t)$, afterwards it would be a full dollar. If the applicable national average marginal tax rate is .34, then the price for itemizers would rise from \$.66 to \$1 for amounts over the new ceiling, with an increase in price of $.34/.83$ or 41 percent. ^{43/} There would be a similar price effect if the limitation approach taken were to eliminate the sales tax deduction, because sales tax payments would in effect become the marginal tax dollars, and their price would rise from $\$(1-t)$ to \$1.

The consequences for S-L governments in terms of reduced revenues are potentially of much greater magnitude with the ceiling or sales tax deduction

^{43/} As discussed in footnote 11 in chapter II, it is necessary to average the original and new prices for the base price when calculating the percentage change.

elimination proposals, which have price effects, than with a floor proposal, which has only an income effect. The price elasticity of demand for public goods, discussed in chapter II, is estimated to be $-.5$. Multiplying $-.5$ times the 41 percent $(.34/.83)$ increase in the price of public goods times the \$.34 loss of after-tax income per dollar lost in deductions yields a decrease in spending on S-L taxes of \$.069 per dollar lost in deductions. ^{44/} In contrast, multiplying the marginal spending effect of .10 from the income effect times the \$.34 loss of after-tax income per dollar lost in deductions yields a decrease in spending on S-L taxes of \$.034 per dollar lost in deductions if there is only an income effect.

To reinterpret these marginal effects per dollar in aggregate terms, if the Federal revenue goal is to raise an additional \$6 billion, this suggests that deductions need to be reduced by approximately \$6 billion divided by .34, or \$17.6 billion. (As explained in more detail in appendix C, the S-L deductibility provision may not need to be limited by this full amount to accomplish this Federal revenue goal. This is because the second-round effects of taxpayers' reducing their willingness to pay S-L taxes should further cut the amount of S-L taxes claimed as deductions.) If S-L tax deductions were limited by \$17.6 billion, and S-L taxpayers' after-tax incomes declined by \$6 billion (\$17.6 billion times .34), the above estimates suggest that expenditures on S-L taxes would fall by \$.6 billion under an income effect (\$6 billion times .10); or by \$1.23 billion under a price effect (\$6 billion times .205).

This large difference in the expected influence on S-L revenues emphasizes the point that it would be quite important to State and local governments, if

^{44/} This assumes that all itemizers, or at least the itemizer who is decisive in determining S-L fiscal choices, experience a price effect. The higher the share of deductions disallowed (whether by a ceiling or a floor), the greater the share of taxpayers subject to a price change. At the extreme, if the S-L tax deduction were completely disallowed, all itemizers would suffer a price change.

the Federal Government does decide to restrict deductibility of S-L taxes in order to raise revenues, that it do so in a way that has primarily an income effect and not a price effect.

E. Net Effect on Taxpayers, the State-Local Budget, and the Federal Budget of Increasing General Revenue Sharing and Limiting State-Local Tax Deductibility

This section summarizes the effects on taxpayers, the State-local sector, and the Federal Government of the proposal to increase general revenue sharing to State and local governments by \$6 billion as of FY 1985, and financing that additional Federal spending by either of two methods of limiting the deductibility of State and local taxes under the Federal individual income tax: 1) placing a floor on the amount of all State-local tax deductions, or 2) eliminating the deductibility of State and local sales taxes. ^{45/}

At first glance, it appears that under either limitation approach the Federal Government comes out even, raising \$6 billion in additional revenue through limiting the deduction but spending it on increased general revenue sharing to State and local governments; taxpayers pay an additional \$6 billion in Federal taxes, implying an equivalent reduction in after-tax income; and State and local governments receive an additional \$6 billion in revenues through general revenue sharing.

Over time, however, adjustments can be expected that will affect all three parties. Taxpayers are likely to react to having lower after-tax income by reducing the amount of State and local taxes they are willing to pay. This in turn reduces the revenue to State and local governments. A reduction in State and local taxes paid further reduces the amount of deductions, thereby further increasing Federal tax liabilities and Federal revenues. In addition,

^{45/} The ceiling limitation proposal is not considered here because the findings presented in Chapter V suggest that its effect would vary substantially among the States.

the State-local sector must decide what to do with the additional GRS revenue it receives--whether to use it to increase spending or to share it with taxpayers by lowering S-L taxes; the allocation between these two uses may well change over time, and will affect the Federal as well as State-local and taxpayer budgets.

The purpose of this section is to make rough estimates of the dollar magnitude of these many offsetting behavioral adjustments in order to comment on the expected net effect of the proposal on taxpayers, the State-local sector, and the Federal Government. These effects and a rough estimate of their dollar magnitude are presented in three tables, one for each of these groups. (An analysis of these effects in more formal algebraic terms is presented in appendix C.)

Each table contains two parts. The first part represents the response in the short-run. This is a period in which taxpayers are arbitrarily assumed to adjust their willingness to pay taxes in reaction to their new income and substitution effects, but in which the S-L sector does not adjust and is credited with the full amount of additional GRS funds. The second part represents a long-run response, after the S-L sector has the time to decide how much of the GRS assistance to use for increased spending and how much to return to taxpayers in the form of reduced S-L tax payments. ^{46/} Based on the findings of studies of S-L behavior in response to intergovernmental assistance during the 1970s, the CRS estimates assume that in the long run, S-L governments spend 40 percent of the GRS monies and return 60 percent as S-L tax relief. ^{47/}

Under the proposals to raise Federal revenues by limiting the deductibility of S-L taxes, only taxpayers who itemize deductions on their Federal individual

^{46/} The adjustments of taxpayers and the S-L sector will actually be occurring simultaneously over time. This arbitrary distinction better enables the exposition to separate their different effects.

^{47/} Inman (1979) reviews many estimates of the State-local spending response of the receipt of GRS funds and finds the 40 percent estimate to be in the middle of the range.

vidual income tax return would directly experience the income and perhaps the price effect just described. They are the citizens who would be motivated to reduce their payment of S-L taxes as a direct result of this policy change. But the decision to cut S-L taxes is a political one. ^{48/} Whether S-L taxes are actually cut would depend on the political balance between itemizers and nonitemizers, including people with no tax liability.

If the S-L budget decision-making process is dominated by nonitemizers and nontaxpayers who are not sensitive to this change in Federal tax policy, it is possible that the decreased after-tax incomes of itemizers would not have a dampening effect on S-L own-source revenues. However, the results presented here are based on the alternative assumption that itemizers dominate the determination of the level of S-L taxes and expenditures.

Basically the same analysis is repeated, first for the proposal to place a floor on all State-local tax deductions and, second, for the proposal to eliminate the deductibility of State and local sales taxes. The main source of difference in the estimates comes from the assumption that the taxpayers will respond to the floor proposal through an income effect of .10, and to the sales tax deduction limitation proposal by a price effect of .205. Thus, the negative effect on State-local own-source revenues is expected to be twice as large under the sales-tax compared to the floor proposal.

1. Proposal to Place a Floor on All State-Local Tax Deductions

Effect on After-Tax Income of Taxpayers--Floor Proposal

This discussion assumes that the portion of deductions disallowed would be set at a level sufficiently low that most itemizers would still have S-L

^{48/} Only the 16 States that permit Federal taxes to be deducted from income subject to State income tax would experience an automatic reduction in revenue as a result of the restriction in the deduction causing an increase in Federal tax liability.

tax payments in excess of the floor. Under these conditions, most itemizers would be influenced by an income effect but not a price effect.

In the short run, taxpayers' after-tax incomes fall by \$5.6 billion, for essentially two reasons. First, the change in the tax law reduces the amount of S-L tax payments eligible for deduction against the Federal income tax base, thereby increasing Federal tax payments. And second, although S-L taxpayers' payment of S-L taxes is reduced, according to the income effect, by 10 percent of their change in after-tax income ($.10 \times \$6 \text{ billion} = \$0.6$), this is partially offset by higher Federal income taxes stemming from reduced deductions against the Federal income tax base ($.34 \times \$0.6 \text{ billion} = \$0.204$).

This reduction in taxpayers' after-tax incomes is partially offset in the long run. If sixty percent of the \$6 billion of GRS appears as S-L tax relief, it raises taxpayers' after-tax incomes by \$3.6 billion. Because this second-round reduction in S-L tax payments of \$3.6 billion further reduces S-L tax deductions, Federal tax payments are higher by \$1.224 billion. ^{49/} In the long run, taxpayers' after-tax incomes are lower by \$3.228 billion.

<u>Effect on After-Tax Income of Taxpayers--Floor Proposal</u>		<u>\$ Billion</u>
Disallowance of \$17.6 billion in S-L tax deductions, yields higher Federal tax payments ($.34 \times \$17.6$)		-6.0
Reduction of S-L tax payments ($.10 \times \$6$)		+0.6
Increased Federal tax payments ($.34 \times \$0.6$)		-0.204
TOTAL, SHORT-RUN		-5.604
S-L tax relief from GRS ($0.6 \times \$6$)		+3.6
Decrease in S-L tax liability leads to higher Federal tax payments ($.34 \times \$3.6$)		-1.224
TOTAL, LONG-RUN		-3.228

^{49/} This assumes all the tax relief from GRS goes to itemizers, and thus obviously overstates the increase in Federal tax payments.

Effect on State-Local Budgets--Floor Proposal

In the short run, S-L budgets are larger by \$5.4 billion because the Federal Government increases GRS by \$6 billion. The only offset to the \$6 billion of GRS is the \$6 billion reduction in S-L tax payments attributable to their citizens' reactions to reductions in their after-tax incomes as a result of limiting Federal deductions. This increase in S-L budgets is partially offset in the long run. If sixty percent of the \$6 billion of GRS is returned to taxpayers as tax relief, this leaves but \$2.4 billion to be added to S-L budgets. In the long run, the S-L budget is higher by \$1.8 billion.

Effect on State-local Budgets--Floor Proposal

	S Billion
Reduction in own-source revenues stemming from disallowance of S-L tax deductibility (.10 x \$6) ^{50/}	-0.6
Receipt of GRS	+6.0
TOTAL, SHORT-RUN	+5.4
60 percent of GRS spent on S-L tax relief (.60 x \$6.0)	-3.6
TOTAL, LONG-RUN	+1.8

Effect on the Federal Budget--Floor Proposal

In the short-run, the Federal Government's budget position improves slightly, by \$0.204 billion. Although the disallowance of deductibility of some S-L tax payments against Federal taxable income increases Federal tax receipts, this is exactly balanced by the increased GRS payments. The improvement occurs

^{50/} This is actually a slight underestimate of the reduction in State-local own-source revenues. As noted in the previous table, Federal tax payments would rise by .204 billion. This reduction in after-tax income would again cause S-L taxpayers to reduce S-L tax payments. Using the notation from Appendix C, the actual size, after all adjustments are completed, of the reduction in S-L tax payments is: $dD(yt + y^2t^2 + \dots + y^nt^n)$. This is approximated by $[(1 - y^nt^n)/(1 - yt)]yt$. For this proposal, the actual reduction in S-L tax payments would be \$0.6195 billion. Offsetting adjustments would occur in the other variables, as explained in the text.

because the deductibility limitation reduces the after-tax income of S-L taxpayers and causes them to reduce spending on S-L taxes, which in turn further reduces deductions and increases Federal tax receipts. In the long run, the Federal Government's budget position is further improved. The \$3.6 billion in S-L tax relief from the receipt of \$6.0 billion of GRS further reduces S-L tax deductions against the Federal income tax base and increases Federal tax revenues. In the long run, the Federal budget is higher by \$1.428 billion.

<u>Effect on the Federal Budget--Floor Proposal</u>		<u>\$ Billion</u>
Disallowance of S-L tax deductibility increases Federal tax revenues		+6.0
Reduction of S-L taxes increases Federal tax revenues (.34 x \$0.6)		+0.204
Increased GRS payments		-6.0
TOTAL, SHORT-RUN		+0.204
S-L tax relief from GRS increases Federal tax receipts (.34 x \$3.6)		+1.224
TOTAL, LONG-RUN		+1.428

2. Proposal to Eliminate the Deductibility of Sales Taxes

Disallowing the deductibility of State and local sales taxes raises the net price of \$1 of sales tax payment from \$.66 to \$1.00. Thus, in addition to the income effect of .10 found in the case of the floor proposal, a substitution effect is also present in this case. The value of the combined income and substitution effects, or price effect, is .205. This larger response of taxpayers to the limitation of deductions has ramifications throughout the calculation of net effects.

Effect on After-Tax Income of Taxpayers--Sales Tax Proposal

In the short run, taxpayers' after-tax incomes fall by almost \$5.2 billion for essentially two reasons. First, the change in the tax law reduces the amount of S-L tax payments eligible for deduction against the Federal income

tax base, thereby increasing Federal tax payments. And second, although S-L taxpayers' payment of S-L taxes is reduced by almost 21 percent of their change in after-tax income ($.205 \times \$6 \text{ billion} = \$1.23$), this is partially offset by higher Federal income taxes stemming from reduced deductions against the Federal income tax base ($.34 \times \$1.23 \text{ billion} = \$0.4182$).

This reduction in taxpayers' after-tax incomes is partially offset in the long run. If 60 percent of the \$6 billion of GRS appears as S-L tax relief, it raises taxpayers' after-tax incomes by \$3.6 billion. Because this second-round reduction in S-L tax payments of \$3.6 billion further reduces S-L tax deductions, Federal tax payments are higher by \$1.224 billion. Taxpayers' after-tax incomes are in the long run lower by \$2.8122 billion.

Effect on After-Tax Income of Taxpayers--Sales Tax Proposal

	\$ Billion
Disallowance of \$17.6 billion in S-L tax deductions, yields higher Federal tax payments ($.34 \times \$17.6$)	-6.0
Reduction of S-L tax payments ($.205 \times \$6$)	+1.23
Increased Federal tax payments ($.34 \times \$1.23$)	-0.4182
TOTAL, SHORT-RUN	-5.1882
S-L tax relief from GRS ($0.6 \times \$6$)	+3.6
Decrease in S-L tax liability leads to higher Federal tax payments ($.34 \times \$3.6$)	-1.224
TOTAL, LONG-RUN	-2.8122

Effect on State-Local Budgets--Sales Tax Proposal

In the short run, S-L budgets are larger by \$4.77 billion because the Federal Government increases GRS by \$6 billion. The only offset to the \$6 billion of GRS is the \$1.23 billion reduction in S-L tax payments attributable to their citizens' reactions to reductions in their after-tax incomes as a result of limiting Federal deductions. This increase in S-L budgets is partially offset in the long run. If 60 percent of the \$6 billion of GRS is returned to tax-

payers as tax relief, this leaves but 2.4 billion to be added to S-L budgets.

In the long run, the S-L budget is higher by \$1.17 billion.

<u>Effect on State-Local Budgets--Sales Tax Proposal</u>		<u>\$ Billion</u>
Reduction in own-source revenues stemming from disallowance of S-L tax deductibility ($.205 \times \$6$)		-1.23
Receipt of GRS		+6.0
TOTAL, SHORT-RUN		+4.77
60 percent of GRS spent on S-L tax relief ($.60 \times \$6.0$)		-3.6
TOTAL, LONG-RUN		+1.17

Effect on the Federal Budget--Sales Tax Proposal

In the short run, the Federal Government's budget position improves slightly, by \$0.4182 billion. Although the disallowance of deductibility of some S-L tax payments against Federal taxable income increases Federal tax receipts, this is exactly balanced by the increased GRS payments. The improvement occurs because the deductibility limitation reduces the after-tax income of S-L taxpayers and causes them to reduce spending on S-L taxes, which in turn further reduces deductions and increases Federal tax receipts. In the long run, the Federal Government's budget position is further improved. The \$3.6 billion in S-L tax relief from the receipt of \$6.0 billion of GRS further reduces S-L tax deductions against the Federal income tax base and increases Federal tax revenues. In the long run, the Federal budget is higher by \$1.6422 billion.

<u>Effect on the Federal Budget--Sales Tax Proposal</u>		<u>\$ Billion</u>
Disallowance of S-L tax deductibility increases Federal tax revenues		+6.0
Reduction of S-L taxes increases Federal tax revenues ($.34 \times \$1.23$)		+0.4182
Increased GRS payments		-6.0
TOTAL, SHORT-RUN		+0.4182
S-L tax relief from GRS increases Federal tax receipts ($.34 \times \$3.6$)		+1.224
TOTAL, LONG-RUN		+1.6422

The long-run results are compared in the following summary table. Taxpayers are slightly better off with the sales tax proposal than with the floor limitation proposal because their after-tax income declines by approximately \$.4 billion less. This difference is attributable to the fact that they are motivated to reduce their S-L tax payments more with the sales tax proposal than with the floor proposal (.205 of the change in after-tax income compared to .10).

Summary of Long-Run Net Effects
(Dollar amounts in billions)

	<u>State-Local Deductibility-Limitation Proposals</u>	
	<u>One Percent of AGI Floor</u>	<u>Eliminate Deducti- bility of Sales Tax</u>
<u>Long-Run Net Effect of:</u>		
Taxpayers	\$ -3.228	\$ -2.8122
State-Local Budgets	1.8	1.17
Federal Government	1.428	1.6422

Since it is the difference in S-L tax payments which determines the effect on taxpayers, it is to be expected that S-L budgets are somewhat better off with the floor proposal than with the sales tax proposal. S-L taxes (and, spending, given a balanced budget) are higher by approximately \$.6 billion with the floor proposal. The Federal Government, in contrast, is approximately \$.2 billion better off with the sales tax proposal. This is attributable to the interaction of the Federal and S-L tax systems. Every additional dollar of S-L tax reduction caused by taxpayers' response to the sales tax proposal's substitution effect also reduces deductible S-L taxes and increases Federal revenues.

F. Potential Own-Source Revenue Loss for Each of the States

This section calculates and compares the potential own-source tax revenue losses from the floor and sales tax deduction elimination proposals for each of the fifty States and the District of Columbia. The estimates are based on 1980 Federal individual income tax data. The U.S. totals in these estimates are not, therefore, comparable to the estimates in section E, which are benchmarked at raising \$6 billion in additional Federal revenue in FY 1985. The primary focus of these State-by-State estimates is to examine the variability across States in the potential loss of own-source tax revenues. The issue is whether one proposal imposes a more uniform potential revenue loss across States than the other.

Because the population and budget size of the States differ so much, it is helpful to compare the potential tax revenue losses relative to some measure of budget size. Column 1 of table 8 shows the total of all tax revenues raised by S-L governments in each State in fiscal year 1979-80.

The potential loss of tax revenues from eliminating sales tax deductibility is presented in column 2. It is calculated by first multiplying the actual sales tax deductions claimed by itemizers from that State for tax year 1980 (see chapter V, table 6, column 2) by the average marginal tax rate assigned to itemizers in each State (see chapter V, table 5, column 2). This provides an estimate of the decrease in after-tax income of taxpayers. This is equivalent to the increase in Federal tax payments. Since elimination of the sales tax deduction is expected to have a price effect, S-L tax revenues are expected to decline by .205 of this income decrease. This potential revenue loss divided by total tax revenues is presented in column 4 of table 8. The loss does not exceed one-half of one percent of total State-local tax revenues for any State, and averages .32 percent for the United

TABLE 8
Potential Revenue Loss as a Percent of 1980 Total Tax Revenue, by State:
One-percent-of-AGI Floor and Elimination of Sales Tax Deductibility

	(1)	(2)	(3)	(4)	(5)
	Total S-L Tax Revenue	Potential Loss of S-L Tax Revenue Sales Tax	1% AGI	Potential Loss of S-L Tax Revenue as % of Total S-L Tax Revenue Sales Tax	1% AGI
	\$ mill.	\$ mill.	\$ mill.	%	%
ALABAMA	2528.4	11.1	3.3	.44	.13
ALASKA	1675.5	.9	1.1	.05	.06
ARIZONA	2738.2	10.5	3.3	.38	.12
ARKANSAS	1495.3	2.9	1.4	.19	.09
CALIFORNIA	27745.5	110.6	36.0	.40	.13
COLORADO	2859.2	11.5	4.4	.40	.15
CONNECTICUT	3326.4	16.2	5.7	.49	.17
DELAWARE	629.9	.2	.9	.03	.15
DIST. COLUMBIA	940.9	2.0	1.2	.22	.12
FLORIDA	7381.6	20.6	9.9	.28	.13
GEORGIA	4207.0	11.7	5.4	.28	.13
HAWAII	1232.8	4.1	1.4	.34	.11
IDaho	712.0	1.7	.9	.23	.12
ILLINOIS	12375.2	47.4	17.0	.38	.14
INDIANA	4083.1	10.7	4.9	.26	.12
IOWA	2817.6	5.0	3.2	.18	.11
KANSAS	2188.4	5.4	3.1	.25	.14
KENTUCKY	2709.3	7.0	3.0	.26	.11
LOUISIANA	3534.0	9.7	3.3	.27	.09
MAINE	965.5	1.8	.7	.19	.08
MARYLAND	4655.5	14.4	6.9	.31	.15
MASSACHUSETTS	7132.2	12.9	7.5	.18	.10
MICHIGAN	8956.4	29.7	15.6	.30	.16
MINNESOTA	4585.5	9.1	5.6	.20	.12
MISSISSIPPI	1629.6	5.1	1.7	.31	.10
MISSOURI	3743.3	11.3	4.6	.30	.12
MONTANA	786.8	.1	.7	.01	.09
NEBRASKA	1512.3	3.5	1.5	.23	.10
NEVADA	776.8	1.9	1.0	.25	.13
NEW HAMPSHIRE	681.5	.2	.9	.04	.13
NEW JERSEY	8376.5	24.2	11.8	.29	.14
NEW MEXICO	1143.0	3.2	1.8	.28	.09
NEW YORK	26245.5	83.4	24.4	.32	.09
NORTH CAROLINA	4395.2	10.5	5.1	.24	.12
NORTH DAKOTA	553.0	.8	.5	.14	.09
OHIO	8747.7	20.3	10.7	.23	.12
OKLAHOMA	2580.7	7.0	3.3	.26	.13
OREGON	2576.5	.3	3.3	.01	.13
PENNSYLVANIA	11605.9	27.5	13.2	.24	.11
RHODE ISLAND	939.9	2.1	.9	.23	.10
SOUTH CAROLINA	2289.1	6.7	2.6	.30	.12
SOUTH DAKOTA	544.1	1.2	.4	.22	.07
TENNESSEE	3012.3	10.6	3.2	.35	.11
TEXAS	11466.3	37.6	17.6	.33	.15
UTAH	1226.8	4.7	1.5	.38	.12
VERMONT	459.9	.5	.4	.10	.08
VIRGINIA	4574.1	13.2	6.5	.29	.14
WASHINGTON	4083.9	14.4	4.6	.35	.12
WEST VIRGINIA	1551.7	2.0	1.1	.13	.07
WISCONSIN	4993.9	11.5	5.7	.23	.11
WYOMING	659.1	1.3	.5	.20	.08
US TOTAL	223462.6	719.8	296.9	.32	.13

Sources: See next page

Sources for table 6 listed by column number:

- (1) Total State-local tax revenue for fiscal year 1979-80 from U.S. Bureau of the Census. Governmental Finances, 1979-80. Washington, U.S. Govt. Print. Off., 1981. Table 5 on pages 18-26.
- (2) Calculated by CRS as explained in the text, based on data developed in chapter V. Equal to the marginal tax rate (column 2 of table 5), times the loss of sales tax deductions (column 2 of table 6), times the estimate of the price effect of .205.
- (3) Calculated by CRS, as explained in the text, based on data developed in chapter V. Equal to the marginal tax rate (column 2 of table 5), times the loss of deductions by the amount of one percent of AGI for itemizers (column 2 of table 7), times the estimate of the income effect of .10.
- (4) Column 2 divided by column 1.
- (5) Column 3 divided by column 1.

States as a whole. (Note that even taxpayers in those States without a sales tax--Alaska, Delaware, Montana, New Hampshire, and Oregon--experience some revenue loss, because their taxpayers can deduct sales taxes paid to other States.)

The potential own-source revenue loss from imposition of a one percent of AGI floor on all State-local tax deductions is presented in column 3. It is calculated by first multiplying the aggregate AGI for itemizers by .01, and then by the marginal tax rate. This provides an estimate of the decrease in after-tax income of taxpayers. Because imposition of the floor is expected to have only an income effect, the drop in after-tax income is multiplied by .10 (rather than .205 in the case of the sales tax proposal) to estimate the potential revenue loss for each of the States. This potential revenue loss divided by total tax revenues is presented in column 5. The loss associated with the percent of AGI floor proposal does not exceed .17 percent of total State-local tax revenues in any State, and averages .13 percent for the entire United States.

The difference in the magnitude of the potential revenue loss under the two proposals is explained in small part by the point made in chapter V, table 2, based on national aggregate figures, that the one percent of AGI floor was anticipated to yield slightly less additional Federal revenue than eliminating the deductibility of the sales tax. The far larger source of difference behind the estimates presented in table 8 is the expectation of an income-effect response of .10 to the floor proposal, but a price effect response of .205 to the sales tax proposal.

In addition to the differences in the magnitude of the potential own-source revenue losses from the two proposals, the expected degree of variation in their impact among the States is important. Considerations raised in chapter V suggested that in those States which either do not levy a sales tax or raise only small amounts of revenue from it, elimination of sales tax

deductibility would impose a relatively small burden on their taxpayers. In contrast, essentially all States and local governments levy some taxes which are deductible from Federal taxable income and which generally amount to more than one percent of AGI for the average itemizer. The floor proposal is therefore expected to distribute the revenue loss more uniformly among States. The estimates in columns 4 and 5 confirm this expectation. The variability of the potential revenue loss from the sales tax proposal--.40--exceeds the variability of potential revenue loss for the floor proposal--.21. ^{51/}

Thus, the calculations presented here in chapter VI provide two reasons to select the percent-of-AGI floor approach rather than the elimination of the sales tax deduction as the preferable method for limiting the deductibility of State and local taxes. First, because it entails only an income effect, the floor approach is expected to have less of a negative effect on S-L own-source revenues than the sales tax approach, which also includes the substitution effect. Second, because it affects taxpayers in all States in a similar manner, the floor approach is expected to have a more uniform effect among the States in reducing taxpayers' after-tax income and their accompanying willingness to pay State and local taxes. Eliminating the deductibility of the sales tax would tend to penalize taxpayers and State-local budgets in jurisdictions that depended heavily on the sales tax, relative to others which levied no sales tax or relied on it only lightly.

^{51/} Variability is measured as the coefficient of variation--the standard deviation divided by the mean.

APPENDIX A: Background Statistics for Analysis of Increased Tax Liability by Income Class (Chapter V).

TABLE A.1. For All Returns: Total AGI and Number;
For Itemized Returns: Number Itemizing State and Local Taxes of
Any Kind, and Number Itemizing Sales Taxes;
All Categorized by AGI Class, 1980.

Size of AGI, 1980 (\$1,000s)	All Returns		Itemized Returns	
	(1) Total AGI (\$1,000s)	(2) Number	(3) Number with S-L Tax Deduction of Any Kind	(4) Number with Sales Tax Deduction
Total	\$1,613,731,497	93,902,469	28,749,278	27,672,787
Under 5	36,905,608	20,055,529	358,201	321,458
5-10	146,638,938	18,370,997	1,288,985	1,208,612
10-15	177,118,036	14,303,041	2,554,228	2,454,253
15-20	193,430,777	11,097,733	3,576,579	3,412,380
20-25	205,478,622	9,158,521	4,647,986	4,463,107
25-30	185,760,754	6,783,466	4,406,178	4,254,248
30-50	408,002,858	11,003,991	8,981,005	8,703,871
50-100	165,927,779	2,568,427	2,395,181	2,327,724
100-200	58,591,220	443,514	425,945	414,846
200-500	28,343,686	100,369	98,301	95,993
500-1,000	8,323,125	12,467	12,315	12,025
1,000+	9,210,095	4,414	4,374	4,270

Note: AGI = Adjusted Gross Income.

Source: Internal Revenue Service. Statistics of Income--1980, Individual Income Tax Returns. Washington, D.C.: U.S. Govt. Print. Off., 1982. (Publication 79 (9-82)) Elsewhere cited as SOI--1980. Data for all returns from table 1.1, p. 36; for returns with State-local tax deductions from table 2.1, p. 56.

TABLE A.2. Average AGI and Average Taxable Income for Returns with Itemized Deductions;
Joint Returns as a Percent of All Returns;
All Categorized by AGI Class, 1980.

Size of AGI, 1980 (\$1,000s)	Returns with Itemized Deductions		
	(1) Average AGI <u>a/</u>	(2) Average Tax- able Income <u>b/</u>	(3) Joint Returns as a Percent of All Returns <u>d/</u>
Total	\$ 32,043	\$ 24,898	48.2 %
Under 5	3,030	1,939 <u>c/</u>	12.0
5-10	7,820	5,005 <u>c/</u>	27.9
10-15	12,663	8,104 <u>c/</u>	40.6
15-20	17,636	12,490	58.8
20-25	22,563	16,746	74.2
25-30	27,491	21,072	84.5
30-50	37,461	29,538	91.0
50-100	64,773	51,635	91.0
100-200	132,290	106,392	89.6
200-500	282,571		89.0
500-1,000	667,516	309,833 <u>b/</u>	84.9
1,000+	2,085,475		80.7

a/ Actual average AGI for itemizers calculated by CRS from data in SOI--1980, table 2.1, p. 56.

b/ Unpublished IRS tabulation from the SOI--1980 file. This tabulation treated retruns with AGI above \$200,000 as a single category.

c/ CRS estimated values for the three AGI classes below \$15,000. The IRS calculated the average taxable income on itemized returns with AGI below \$15,000 to be \$6,559.

d/ Calculated by CRS from data in SOI--1980, table 4.4, p. 104.

TABLE A.3. Estimated Loss of Deduction for an Itemizer under Alternative Proposals, by AGI Class, Based on 1980 Tax Return Data.

Size of AGI (\$1,000s)	(1) 1% of AGI Floor	a/	(2) Fixed Floor \$282/\$564	b/	(3) Ceiling at 6.5% of AGI	c/	(4) Eliminate Sales Tax Deduction	d/
Total	\$ 320		\$ 418		\$ 331		\$ 401	
Under 5	30		316		403		156	
5-10	78		361		339		188	
10-15	127		396		295		250	
15-20	176		448		230		288	
20-25	226		492		251		333	
25-30	275		520		210		372	
30-50	375		538		290		469	
50-100	648		538		647		652	
100-200	1,323		535		1,052		930	
200-500	2,826		533		1,868		1,278	
500-1,000	6,675		521		3,505		2,066	
1,000+	20,855		510		20,056		3,925	

a/ Calculated by CRS as one percent of table A.2, column 1.

b/ A weighted average figure calculated by CRS to account for the substantial difference among the AGI classes in the percent of returns that are joint versus nonjoint. First, the proposed floors of \$375 for single returns and \$750 for joint returns were converted into their 1980 equivalents of \$282 and \$564 by dividing by the GNP deflator, as explained in the text. The weighted average is the sum of the percent of joint returns in the AGI class multiplied times \$564 plus the percent of nonjoint returns multiplied times \$282. The percent of joint returns by AGI class is reported in table A.2, column 3.

c/ Calculated by CRS as the excess of (a) the average taxes deducted by those itemizing State-local taxes (see table 4 in text) over (b) 6.5 percent of table A.2, column 1.

d/ Actual average sales tax deduction for returns itemizing general sales taxes. Calculated by CRS from data in SOI---1980, table 2.1, p. 56.

TABLE A.4. Estimated Increase in Tax Liability for an Individual Itemizer, by AGI Class, 1980 Deduction Data and Tax Rates.

Size of AGI (\$1,000s)	(1) 1% of AGI Floor	(2) Fixed Floor \$282/\$564	(3) Ceiling at 6.5% of AGI	(4) Eliminate Sales Tax Deduction
Total	\$ 115	\$ 150	\$ 119	\$ 144
Under 5	0	0	0	0
5-10	13	61	58	32
10-15	24	75	56	48
15-20	39	99	51	63
20-25	59	128	65	87
25-30	80	151	61	108
30-50	124	178	96	155
50-100	324	269	324	326
100-200	794	321	631	558
200-500	1,978	373	1,308	895
500-1,000	4,673	365	2,454	1,446
1,000+	14,599	357	14,039	2,748

Source: Calculated by CRS by multiplying the weighted average marginal tax rate from table 3 in the text times the estimated loss of deductions from table A.3.

The estimates of increased tax liability are based on actual State and local tax deductions claimed for tax year 1980 on all returns (both taxable and nontaxable) with itemized deductions. Thus the base figures are average deductions and average income within an AGI class. These averages derive from all itemizers in the AGI class, including the returns of single filers, heads of households, and separate returns of married couples as well as joint returns and returns of surviving spouses. This poses a particular problem for two elements of the calculation--the marginal tax rate--which is higher for single returns than joint returns for any given dollar amount of taxable income--and the fixed dollar floor amount which is expressed as twice as large for a joint as a single return. Because there is a substantial difference among AGI classes in the percent of returns that are joint compared with nonjoint, a weighted average was calculated for both the marginal tax rate and the fixed dollar floor for each AGI class.

TABLE A.5. Estimated Increase in Tax Liability as a Percent of AGI for an Individual Itemizer, by AGI Class, 1980 Deduction Data and Tax Rates.

Size of AGI (\$1,000s)	(1) 1% of AGI Floor	(2) Fixed Floor \$282/\$564	(3) Ceiling at 6.5% of AGI	(4) Eliminate Sales Tax Deduction
Total	.36 %	.47 %	.37 %	.45 %
Under 5	0	0	0	0
5-10	.17	.78	.74	.41
10-15	.19	.59	.44	.38
15-20	.22	.56	.29	.36
20-25	.26	.57	.29	.39
25-30	.29	.55	.22	.39
30-50	.33	.48	.26	.41
50-100	.50	.42	.50	.50
100-200	.60	.24	.48	.42
200-500	.70	.13	.46	.32
500-1,000	.70	.05	.37	.22
1,000+	.70	.02	.67	.13

Source: Calculated by CRS from estimates of increase in tax liability for an itemizer in table A.4, divided by average AGI for itemizers in table A.2.

TABLE A.6. Estimated Increase in Tax Liability as a Percent of AGI for the AGI Class as a Whole, 1980 Deduction Data and Tax Rates.

Size of AGI (\$1,000s)	(1) 1% of AGI Floor	(2) Fixed Floor \$282/\$564	(3) Ceiling at 6.5% of AGI	(4) Eliminate Sales Tax Deduction
Total	.20 %	.27 %	.21 %	.25 %
Under 5	0	0	0	0
5-10	.01	.05	.05	.03
10-15	.03	.11	.08	.07
15-20	.07	.18	.09	.11
20-25	.13	.29	.15	.19
25-30	.19	.36	.14	.25
30-50	.27	.39	.21	.33
50-100	.47	.39	.47	.46
100-200	.58	.23	.46	.40
200-500	.69	.13	.45	.30
500-1,000	.69	.05	.36	.21
1,000+	.69	.02	.67	.13

Source: Calculated by CRS by multiplying the estimated increase in tax liability for an individual itemizer from table A.4 times the number of returns itemizing State-local taxes from table A.1, column 3 (for the sales tax proposal, the number itemizing sales taxes from table A.1, column 4), and dividing this by total AGI for the entire AGI class from table A.1, column 1.

APPENDIX B: Background Statistics for Analysis of Increased Tax Liability by State (Chapter V).

TABLE B.1. Percentage Breakdown of State-Local Tax Deductions by Type of Tax, within Each State, 1980.

State	Sales	Income	Real Estate	Personal Property
Alabama	29.36	55.95	10.42	2.50
Alaska	11.97	36.66	44.62	2.31
Arizona	24.88	45.03	23.23	4.96
Arkansas	16.82	58.95	19.24	4.09
California	17.62	56.54	20.18	3.12
Colorado	18.32	48.09	29.02	3.62
Connecticut	19.73	20.31	50.25	5.79
Delaware	1.33	79.19	18.04	.24
DC	9.38	69.38	19.62	.70
Florida	26.64	9.89	52.73	2.49
Georgia	16.73	55.00	23.37	3.61
Hawaii	16.45	65.40	16.28	.56
Idaho	12.87	61.68	24.10	.68
Illinois	21.22	36.28	41.60	.19
Indiana	22.41	40.55	27.42	8.43
Iowa	11.52	55.74	25.77	2.32
Kansas	15.54	49.44	28.97	5.28
Kentucky	16.81	59.91	12.46	2.43
Louisiana	46.33	38.58	10.44	1.84
Maine	14.35	45.07	36.22	3.68
Maryland	11.55	59.91	26.90	.34
Massachusetts	7.92	44.82	42.18	3.90
Michigan	11.26	45.93	40.60	.60
Minnesota	8.55	68.52	28.11	1.76
Mississippi	30.29	43.36	16.91	8.38
Missouri	20.41	46.46	28.37	3.98
Montana	1.12	55.68	33.54	8.80
Nebraska	15.05	44.52	35.53	4.42
Nevada	26.62	10.99	52.04	7.52
New Hampshire	2.09	22.41	70.03	3.52
New Jersey	12.19	35.34	49.72	.24
New Mexico	28.04	46.48	23.05	1.21
New York	13.62	56.42	28.66	.16
North Carolina	13.89	64.20	18.64	1.80
North Dakota	15.88	37.13	45.66	.45
Ohio	16.01	48.82	30.33	2.79
Oklahoma	19.09	53.31	28.58	5.42
Oregon	.56	67.38	38.69	.47
Pennsylvania	13.93	47.83	35.86	.95
Rhode Island	12.34	41.50	38.21	4.60
South Carolina	17.40	61.56	16.33	4.08
South Dakota	30.98	4.80	62.66	.84
Tennessee	45.95	11.43	40.30	.70
Texas	32.82	4.31	58.93	1.82
Utah	20.53	49.11	25.64	4.08
Vermont	6.77	51.39	38.06	1.06
Virginia	13.34	54.17	26.27	5.28
Washington	36.77	7.85	45.28	8.25
West Virginia	16.43	67.41	11.22	3.62
Wisconsin	9.67	57.82	31.95	.20
Wyoming	45.87	8.35	33.85	10.60
US Total	15.94	49.18	31.15	2.13

Source: See next page.

Source for table B.1:

Percentage calculated by CRS from data by State for tax year 1980 on deductions by type of State-local tax obtained from an unpublished Internal Revenue Service (IRS) tabulation.

Each column represents the dollar amount of deductions for that particular tax divided by the total dollar amount of all State and local taxes deducted on tax returns from that State. The percentage may not add to 100 percent across the row because of deductions for certain other minor taxes not reported here.

TABLE B.2. Average Dollar Size of Deduction by Type of State-Local Tax, by State, 1980.

State	All Taxes	Sales	Income	Real Estate	Personal Property
Alabama	1550.85	461.10	907.11	191.56	49.47
Alaska	1597.26	393.91	750.67	839.99	75.42
Arizona	1764.45	445.73	864.04	455.43	111.30
Arkansas	1654.65	287.80	1059.35	370.97	100.05
California	2787.10	497.57	1694.49	668.28	107.55
Colorado	2134.76	394.40	1051.55	688.36	90.47
Connecticut	2474.21	502.50	1826.64	1366.08	186.42
Delaware	2855.20	111.89	2298.47	555.13	167.33
DC	3251.06	319.98	2339.87	913.48	252.26
Florida	1169.57	321.27	1137.85	760.24	247.99
Georgia	2016.79	345.37	1166.27	527.85	90.47
Hawaii	2781.30	466.23	1919.98	567.49	209.62
Idaho	2013.46	264.79	1321.33	531.97	86.77
Illinois	2195.86	474.73	819.47	995.16	157.73
Indiana	1484.37	335.86	614.56	453.38	147.41
Iowa	2126.22	245.71	1243.84	718.82	63.69
Kansas	1960.84	310.90	987.88	627.74	147.70
Kentucky	2068.77	354.95	1273.73	458.98	90.19
Louisiana	994.56	471.42	437.07	197.63	107.41
Maine	2290.80	337.58	1093.52	887.85	110.48
Maryland	3117.32	370.78	1912.96	931.58	184.71
Massachusetts	3350.75	270.28	1556.38	1526.15	157.09
Michigan	2874.17	329.61	1378.92	1277.87	515.05
Minnesota	2981.46	258.75	2124.47	679.58	69.68
Mississippi	1506.86	463.16	718.97	293.85	146.74
Missouri	1789.74	378.21	870.69	572.48	89.53
Montana	1756.34	145.26	1046.81	675.08	202.17
Nebraska	2346.86	356.38	1091.66	976.25	127.05
Nevada	1053.09	288.96	1013.90	609.21	103.15
New Hampshire	1903.02	156.12	1042.65	1413.20	103.36
New Jersey	2054.15	353.75	1036.33	1562.60	149.00
New Mexico	1536.16	443.18	809.89	416.56	148.28
New York	4052.60	559.86	2346.58	1558.59	210.57
North Carolina	2213.01	316.58	1452.64	481.82	152.51
North Dakota	1409.48	229.25	551.50	745.55	85.12
Ohio	1824.67	300.91	912.18	610.67	354.70
Oklahoma	1658.73	330.15	926.10	385.80	113.79
Oregon	2509.34	157.85	1773.19	841.39	216.14
Pennsylvania	2336.19	338.00	1139.29	924.82	157.84
Rhode Island	2846.73	357.39	1226.08	1177.14	181.73
South Carolina	1933.61	342.70	1221.42	363.94	122.33
South Dakota	1413.86	444.44	868.97	964.79	244.92
Tennessee	1136.56	527.18	550.56	524.75	185.84
Texas	1177.99	401.48	808.20	778.44	130.76
Utah	2094.75	438.79	1051.98	600.57	100.45
Vermont	2670.18	187.25	1430.18	1102.07	326.96
Virginia	2438.31	328.51	1380.64	701.65	159.04
Washington	1254.15	476.21	820.94	627.40	135.32
West Virginia	1638.71	272.95	1143.93	219.51	88.99
Wisconsin	3098.69	302.54	1837.34	1093.64	145.22
Wyoming	888.07	413.48	827.50	338.71	122.79
US Total	2466.80	400.85	1404.86	861.97	124.87

Source: See next page.

Source for table B.2:

Calculated by CRS from data from an unpublished IRS tabulation, by State for tax year 1980, containing the number of returns with itemizing and the dollar amount of deductions by type of State-local tax.

The figures presented in table B.2 represent the dollars deducted divided by the number of returns itemizing the deduction for that particular type of tax.

TABLE B.3. A COMPARISON OF DIRECT TAX BURDENS FOR A MARRIED COUPLE WITH TWO DEPENDENTS, BASED ON MEDIAN INCOME REPORTED BY FHA INSURED MORTGAGORS LOCATED IN THE LARGEST CITY IN EACH STATE, 1980 1/

B. Selected State-Local Direct Taxes

City and State by Region 1/	Family Income 1/		Selected State-Local Direct Taxes as a Percent of Family Income--				
	Amount	In Relation to Median City (Percent)	Total Selected Taxes		Loc. Res. Prop. Tax 1/	State-Local Per. Inc. Tax	State-Local General Sales Tax
			Amount	In Relation to Median City (Percent)			
Median City	\$26,085	100	5.8	100	2.3	2.3	1.1
New England	23,442	90	5.6	97	3.2	1.6	0.8
Bridgeport, CT	20,750	80	4.9	84	3.5	2/	1.4
Portland, ME	20,300 2/	78	4.7	81	2.5 3/	1.1	1.1
Boston, MA	24,200	93	9.3	160	4.7	3.9	0.7
Manchester, NH	24,630 3/	95	2.6	45	2.6 4/	2/	2/
Providence, RI	23,633	91	6.7	116	4.0	3.1	0.8
Burlington, VT	26,740 3/	103	5.6	97	2.3 4/	2.8	0.5
Midwest	26,841	103	9.1	158	3.4	4.8	0.9
Urbana, IL	21,359	84	6.6	114	1.7	4.9	0.7
Dist. of Columbia	28,382	109	9.5	164	1.7	4.9	1.0
Baltimore, MD	26,589	102	7.7	133	2.0	4.7	1.0
Newark, NJ	28,960	111	7.9	136	5.3	1.8	0.8
New York, NY	27,046	104	11.8	203	3.8	6.1	1.9
Philadelphia, PA	28,112	108	11.3	195	4.0	6.5	0.8
Great Lakes	27,728	106	7.1	123	2.8	3.2	1.1
Chicago, IL	30,873	118	6.4	110	2.8	2.1	1.5
Indianapolis, IN	25,170	96	4.6	79	1.9	1.7	1.0
Detroit, MI	27,244	104	8.6	148	4.2	3.5	0.9
Cleveland, OH	27,700	106	6.1	105	2.0	3.1	1.0
Milwaukee, WI	27,652	106	9.9	171	3.3	5.7	0.9
Plains	24,158	93	6.1	106	2.6	3.4	1.1
Des Moines, IA	26,666	102	6.9	119	2.6	3.6	0.7
Minneapolis, MN	27,600 3/	106	9.0	155	2.6 5/	5.7	0.7
St. Louis, MO	21,592	83	6.2	107	2.0	2.8	1.4
Omaha, NE	21,583	83	7.0	121	4.5	1.0	1.5
Fargo, ND	26,000	100	4.1	71	2.0	1.5	0.6
Sioux Falls, SD	18,666	72	5.5	95	3.5	2/	2.0
Southeast	22,582	87	5.3	91	1.9	2.1	1.2
Birmingham, AL	22,580	88	5.8	100	1.1	3.2	1.5
Little Rock, AR	21,968	84	6.3	109	2.8	2.5	1.0
Jacksonville, FL	19,946	76	3.1	53	2.2	2/	0.9
Atlanta, GA	24,733	95	6.3	109	2.3	4.7	1.3
Louisville, KY	21,589	83	8.1	140	2.1	4.9	1.1
New Orleans, LA	26,603	102	2.0	34	0.4	0.3	1.3
Jackson, MS	24,567	94	4.8	83	1.9	1.2	1.7
Charlotte, NC	21,900 3/	84	6.5	112	1.8 6/	3.5	1.2
Columbia, SC	19,292	74	5.7	98	2.0	2.4	1.3
Memphis, TN	24,263	93	4.8	83	3.0	2/	1.8
Norfolk, VA	22,938	88	5.7	98	1.6	1.1	1.1
Huntington, WV	20,200	77	4.3	74	1.8	1.6	0.9
Southwest	27,853	107	4.5	77	2.1	1.1	1.3
Phoenix, AZ	26,245	101	5.7	98	2.1	2.3	1.3
Albuquerque, NM	27,290	105	4.6	79	2.5	0.7	1.4
Oklahoma City, OK	24,392	94	3.9	67	1.1	1.5	1.3
Houston, TX	31,486	121	3.7	64	2.6	2/	1.1
Rocky Mountain	25,288	97	5.4	93	2.2	2.2	1.6
Denver, CO	25,844	99	5.8	100	2.5	2.0	1.3
Boise, ID	27,142	104	6.2	107	1.9	3.5	0.8
Billings, MT	21,045	81	5.2	90	2.9	2.3	2/
Salt Lake City, UT	26,326	101	7.3	126	2.3	3.5	1.5
Cheyenne, WY	26,085 2/	100	2.5	43	1.2 2/	2/	1.3
Far West	30,956	119	4.9	84	2.3	1.8	0.8
Los Angeles, CA	30,581	117	5.8	100	2.0	2.5	1.3
Las Vegas, NV	28,670	110	3.4	59	2.6	2/	0.8
Portland, OR	27,552	106	7.3	126	3.1	4.2	2/
Seattle, WA	30,736	118	2.9	50	1.8	2/	1.1
Anchorage, AK	30,428	117	2.7	47	2.7	2/	2/
Honolulu, HI	29,769	114	7.2	124	1.6	4.3	1.3

1/ Income and property tax data are for FHA "Selected Housing Areas" whose boundaries conform to MSA definitions and are for 1980 FHA insured existing mortgages only, which represent small and varying percentages (by state) of total single-family homes. These amounts may or may not be representative of all homes in a particular state.

All other data are for the largest city in each state.

2/ No broad-based personal income tax.

3/ State of Maine data for the 4th quarter of 1977 increased to 1980 on the basis of the U.S. average annual percentage change. Portland data not available.

4/ State data, increased from 1972 on the basis of the U.S. average annual percentage change.

5/ No general sales tax.

6/ Estimated. 1979 data increased to 1980 on the basis of the U.S. average percentage change.

7/ State data. Cheyenne data not available.

Note: In computing personal income tax liabilities, estimated itemized deductions were assumed. Estimated state-local sales tax liabilities are based on the amounts allowed by the Internal Revenue Service as deductions in computing federal personal income taxes. Regional totals are unweighted averages.

Source: Reproduced from Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1980-81 Edition, Pub. M-132, Washington, D.C., Table 32, p. 51.

APPENDIX C: The Federal Offset and the Income Effect (Chapter VI).

The analysis discussed in Chapter VI of the report can be represented in more formal algebraic terms using the following definitions:

- R = State-local (S-L) tax payments
- D = State-local tax deductions against the Federal income tax base
- d = the percentage of deductions disallowed by the proposed floor
- t = the average Federal marginal tax rate of itemizers
- y = the marginal spending response of S-L taxpayers to an income change (the income effect)

The first task is to calculate the change in S-L own-source tax revenues likely to be caused by the introduction of a floor for S-L tax deductibility against the Federal income tax base. The second task is to determine whether the increase in Federal tax revenues is adequate to compensate the S-L sector for the reduction in its revenues.

The model assumes a balanced State-local budget, with no substitution for tax receipts of non-tax revenues or borrowing.

From the point of view of Federal tax itemizers, State-local tax payments, R, can be decomposed into two parts:

$$(1) R = (R - tD) + tD$$

The second term on the right hand side of the expression, tD , is known as the Federal offset. It is the amount by which Federal tax payments are reduced or, what is the same thing, the amount by which Federal itemizers' after-tax incomes are increased, by having S-L taxes be deductible against the Federal income tax base. The first term on the right hand side of the expression, $R - tD$, is the net amount by which S-L payments reduce S-L taxpayers' after-tax incomes.

Now let a floor be introduced which disallows d percent of deductions D. ^{52/}

^{52/} None of the proposals under examination is expressed in terms of limiting a percent of deductions. This notation represents a reinterpretation of the aggregate dollar amount of deductions that would be disallowed by a given proposal as a percentage, d , of previously eligible deductions, D. For example, for the one percent of AGI floor proposal, the d in this model is calculated as the summation of AGI for all itemizers, multiplied by .01 (or whatever percentage at which the floor is set), and divided by D.

Assume for the moment that S-L taxpayers do not react to this fall in after-tax income by reducing their willingness to pay S-L taxes, so that R remains constant. Receipts can now be decomposed in the following way:

$$(2) \quad R = (R - tD + tdD) + (tD - tdD)$$

The expression dD represents the dollar value of disallowed deductions, and tdD represents the increased Federal tax payments caused by this disallowance. For this reason, tdD is subtracted from the initial level of Federal tax savings in the second term, tD , to give an expression for Federal tax savings after imposition of the floor: $(tD - tdD)$. By definition, this same amount, tdD , must be added to the first term of the expression. That is, the after-Federal-tax cost of S-L taxes rises by tdD to: $(R - tD + tdD)$.

Now assume that S-L taxpayers react to this decrease of tdD in their after-tax incomes by adjusting the amount of S-L taxes they are willing to pay. Assume further that all the decreased tax payments had been deductible against the Federal income tax. If the change in willingness to pay taxes equals y percent of the income change, such as the income effect of .10 referred to in Chapter VI, then R declines by $ytdD$. This reduction is entered straightforwardly on the left-hand side of the expression representing S-L revenues. For itemizers, represented on the right-hand side, this reduction in S-L tax payments also means a decrease in eligible deductions and a consequent increase in Federal tax liability. That is, itemizers see part, t percent, of the decreases S-L tax payments as an increase in Federal tax liability, $t(ytdD)$, and only the remainder, $(1-t)(ytdD)$, as a net increase in after-tax income.

These increases are subtracted from the second and first expressions, respectively, of the right-hand side of equation (2). The amount of the second term of the expression, the amount by which itemizers' after-tax

incomes are increased by S-L taxes being deductible against the Federal income tax base, is further reduced by $t(ytdD)$. This in turn means that the amount in the first term, the amount by which S-L tax payments reduce S-L taxpayers' after-tax income, is reduced by $(1-t)ytdD$. Equation (3) summarizes these adjustments:

$$(3) \quad R - ytdD = [(R - tD + tdD) - (1-t)ytdD] + [(tD - tdD) - t(ytdD)]$$

This expression simplifies to:

$$(4) \quad R - ytdD = [R - tD + tdD(1 - y + yt)] + [tD - tdD(1 + yt)]$$

In sum, the decline in S-L tax receipts associated with a floor that reduces allowable deductions by dD is $ytdD$. The increase in Federal tax revenues from the introduction of the floor is $tdD(1 + yt)$. Thus, provided that $tdD(1 + yt)$ is greater than $y(tdD)$, the Federal Government will increase its revenues enough to be able to compensate the S-L sector for the reduction in its revenues. This condition will always hold because $(1 + yt)$ is always greater than y .